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Accounting News And Trends

Some Comments on Materiality

There are three related but distinct phases to the question of materiality according to Mr. Ernest J. Hicks in "Some Comments on Materiality" (THE ARTHUR YOUNG JOURNAL April 1958). The first involves presentation and reporting; the second, the development of the audit program; and the third, the execution of the program.

Most of the references to materiality in authoritative accounting literature concern the first phase and the decision will normally turn upon the relation between the amount of the item in question and an appropriate basis of comparison. The selection and use of the criterion by which the materiality of the questioned item will be determined call for the exercise of the highest degree of judgment.

In developing the audit program, decisions as to materiality take two general forms. One is the determination of minimum amounts of items to be examined in connection with audit procedures; for example, in testing internal control over cash disbursements, the auditor may decide not to examine invoices with respect to any checks under $100. In establishing minimums, the basic principle is that they should be set low enough so that the product of the number of expectable erroneous items under the minimum and the average amount of such items will not be sufficiently substantial to constitute a material amount. The other aspect involves the determination of how far to go in investigating exceptions that arise in the audit. For example, if during the year the client has purchased a minority interest in a company whose securities are not actively traded, the extent of the examination of the investment will be influenced by the amount of the item and its relation to other amounts in the client's financial statements.

In the carrying out of the audit program a proper consideration of materiality enables the auditor to avoid the inconsequential. For example, in verifying prepaid insurance, an error of $238 can almost certainly be disregarded, or at most, simply called to the client's attention. On most engagements amounts many times larger than this could be viewed similarly, unless they were part of a pattern of errors in which case extension of tests or other appropriate action would be required.

The author makes an important point with respect to materiality and working paper content. Immateriality is never a proper basis for including inaccurate information in audit papers. Materiality should be considered, at the proper staff level, in deciding what information is to be included. However, once a decision is made, information placed in the papers should be complete and accurate. If it is felt desirable to use approximations, they should be clearly labeled as such and the means of arriving at them disclosed.

Proposed Changes in AICPA's Rules of Professional Conduct

The NEWSLETTER (July 1958) of the Arkansas Society of Certified Public

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ACCOUNTING NEWS AND TRENDS *is conducted by* CHARLES L. SAVAGE, CPA *and member of the New York Bar. He is presently serving as a member of our Society's Committee on Legislation.*

Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College.

Accountants reprinted a letter from the Committee on Professional Ethics of the AICPA addressed to State Societies and State Boards of Accountancy proposing changes in the Rules of Professional Conduct. The letter solicited "an expression of opinion and constructive criticism" on these three proposals:

1. An addition to Rule 7 stating that ". . . a member shall not perform any services for a former client of another public accountant without prior notice to such predecessor accountant." This will make mandatory a procedure which the Committee has recommended for many years as an important matter of professional courtesy.

2. Rule 10 (a) should be changed to read, "Publication in a newspaper, magazine or similar medium of an announcement or what is technically known as a card is prohibited." This is intended to eliminate publication of so-called cards announcing change in partnership, establishment of a new office, or a change of address.

3. Rule 10 (b) which pertains to a paid listing in a directory should be changed to add specific language prohibiting the listing of the same name in more than one place in a classified directory. Although this matter is being controlled by most state societies, it is believed desirable that there be uniformity throughout the country.

Auditing Standards and the Audit of Municipalities

Continuing the discussion of the educational bulletins issued by the Kansas Society of CPAs on "Auditing Standards and the Audit of Kansas Municipalities" (see August 1958 issue), let us now consider Bulletin No. 2. It discusses the Audit Report and was released in the Kansas Society's NEWSLETTER of June 2, 1958.

The results of the accountant's examination should be reflected in his report to the governing body, and in-

formative disclosures, whether in the financial statements or in the comments, are to be regarded as reasonably adequate unless otherwise stated in this report. The basic guides that the municipal accountant has available to determine if his disclosures are "reasonably adequate" are set forth in the Minimum Standard Audit Program for Municipalities of State of Kansas. It should be noted that this audit program in no way limits the disclosures that are to be made or the audit procedures that are to be completed. Indeed, the preface to the Minimum Standard Program states: "The accountant will be held responsible for error, regardless of whether or not the requirements are specifically stated in the program, if his work has not been performed in a competent manner."

The first of the more common deficiencies noted by the Kansas Department of Post-Audit concerns the reporting on the review of office procedure and internal control. Any procedural practice being followed by the municipality which affects its finances or does not lend itself to adequate internal control shall be discussed in the report. Violations of statutory provisions must be cited in the report. Where there is a variation of interpretations of the statutes applicable to accounting procedures, the accountant should base his recommendations upon interpretations furnished by the Department of Post-Audit and the Attorney General's office.

The form and content of the report required by the statute is set forth in the Minimum Standard Audit Program which also lists essential financial statements that are to be included. The statements required, however, may not necessarily be limited to those listed. Here are some of the fundamental statements required:

1. Comparison of Available Cash Balances with Encumbrances.

2. Statement of Expenditures Com-

pared with Appropriations—by item, by fund.

3. Statement of Revenue, Estimated and Actual—by item, by fund.

4. Classified Statement of Receipts, Disbursements and Balances of Cash. (Receipts should be reported by source and disbursements by purpose.)

5. Schedule of Insurance on Municipal Property.

6. Schedule of Fidelity Bonds of Elective and Appointive Officers.

A Proposal for a Changing Tax Rate on Depreciation

An interesting suggestion for alleviating the inequity in the treatment of depreciation under the present tax law is presented by Mr. A. Carl Tietjen in an article "Some Thoughts on the Price Level Problem and Income Taxation" appearing in THE PRICE WATERHOUSE REVIEW (June 1958). He states that both from a businessman's and economist's point of view it would appear that companies with large cost-based depreciation charges are at a substantial disadvantage under present tax laws and price conditions, since in effect they pay a tax of 52 per cent on the increment in value of facilities used up in the production process. It is for this reason that the contention is often made that heavy industry is in reality taxed at a rate well above 52 per cent under the present law.

From time to time depreciation measures have been enacted to permit companies to deduct depreciation over a shorter period of time but limiting the aggregate of the deductions to original cost. Other methods have been proposed which are based on the concept of applying a price index to cost depreciation to arrive at a computed amount of depreciation allowable for tax purposes, but it is unlikely that such a departure from the cost basis will be enacted into law in the near future.

The author suggests that perhaps the desired tax relief could be obtained

through changing the tax rate on depreciation. Under such a plan, income before deducting depreciation would be taxed at the normal rate, while depreciation would be allowed as a deduction at a higher rate. For example, if the normal rate is 52 per cent and the depreciation rate 75 per cent:

		Rate	Tax
Sales	$1,000,000		
Costs and expenses other than depreciation	700,000		
Income taxable at normal rate....	$ 300,000	52%	$156,000
Depreciation based on cost	50,000	75%	37,500
Income before federal income tax	$ 250,000		$118,500
Federal income tax	118,500		
Net income..	$ 131,500		

Under the present law (ignoring for simplicity the differential on the first $25,000 of taxable income) the tax in the above case would be $130,000 and net income $120,000, the difference of $11,500, of course, being 23 per cent of $50,000.

As pointed out by the author, an obvious criticism of this method is that it allows the same tax benefits for all properties regardless of age, but he believes that even so it would probably yield more equitable results on the whole than the present law. It is simple, it continues the use of the cost basis, and it offers an incentive to construct additional facilities and replace old ones. Moreover, the application of more than one rate in our tax law is not a new concept since capital gains are taxed at 25% as against 52% for ordinary income. The author suggests that the aforementioned criticism could possibly be met by a graduated scale of tax rates on depreciation according to age of properties, starting at a rate a few points above the normal rate for new properties and ranging upward to 100 per cent or even more for properties ten or more years old.

Mr. Tietjen is interested in getting the views of others on his proposal.

Letters to the Editor

Member Education and Rules of Professional Conduct

It would seem appropriate that the Society's Committee on Professional Conduct give publicity to the Society's rules of professional conduct either by a letter to the members or by publishing short articles in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

For instance, Rule No. 12 states that "A member shall not accept . . . any commission or other participation in professional or commercial business referred to others as an incident to his services to clients . . ." However, numerous commercial factors, stationers and others address mail to CPAs, offering, and paying, commissions on business forwarded to them.

Several other State Societies (Michigan, Louisiana, Oregon, etc.) have recently been devoting meetings to the problems of ethics, professional conduct and adequate audit reports. Our Society should adopt a more aggressive attitude both in relation to member education and to the enforcement of its rules of professional conduct and practice. In this latter connection, I would suggest that letters be written to banks, factors and other credit grantors requesting examples of substandard reports or auditing work, to be used for educational purposes.

STEPHEN CHAN, CPA
(Eisner & Lubin)
New York, N.Y.

A Ruling on New York Stock Transfer Taxes

It has been called to our attention that the Security Traders Association of New York, Inc. has recently received a ruling from the New York Department of Taxation and Finance which may be of interest to some readers of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

Inquiry had been made as to the applicability of a New York stock transfer tax on certain transactions as follows:

"Broker "A" in Atlanta, Georgia, calls by teletype Broker "B" in New York, telling "B" that he wants to buy 100 shares of "X" stock at a specified price. "B" states that he cannot sell at that price, but advises it can be bought from Broker "C" in New York. At "A's" request, "B" conveys "A's" message to "C" and then relays "C's" offer to sell to "A", which "A" accepts. Subsequently "A" and "C" forward written confirmations of their trade to each other. The transaction is in no way reflected on "B's" books of account, for "B" has no financial interest in the transaction and received no benefit other than the goodwill of the parties.

"Assuming the securities are shipped by "C" to "A" in Atlanta, sight draft attached, for collection and payment, is a New York State Transfer Tax due on the transaction? If so, from whom?"

To the above, Deputy Commissioner Mortimer M. Kassell replied:

"In the above situation, it appears that "B" is acting as a mere conduit or transmitter of the offer and acceptance. "B" is not acting on his own behalf nor as an agent for either party but is merely relaying information over his private wire. He is not compensated for his acts but renders such services as a courtesy to his customers. While not obligated to do so, it appears that such services are customary in the trade. The fact that he relays the offer and acceptance to the contracting parties does not make him a party to the contract arising by virtue of the exchange of messages.

"As you know, the taxability of a particular teletype transaction depends,

of course, upon an examination of all the facts and circumstances in each case. I believe that you are familiar with the principles involved, but in the event that a taxable transaction has occurred by virtue of the exchange of messages relayed by "B", it is my opinion that "B" could not be held liable for the payment of any stock transfer taxes due. Subdivision 3 of Section 270 of the Tax Law provides:

> It shall be the duty of the person or persons making or effectuating the sale or transfer, including the person or persons to whom the sale or transfer is made, to pay the tax provided by this article.

"B's" actions in relaying the messages between the parties do not place him in the position of 'making or effectuating the sale or transfer' and liable for payment of the tax any more than a telegraph or telephone company could be held liable for the payment of taxes due on transactions relayed over its facilities."

SIDNEY BLUMENBERG, CPA
Chairman of our Society's
Committee on New York State Taxation

Tax Practice and the Smaller CPA Firm

The article, "Tax Specialization in Accounting Practice," by Mr. Leslie Mills, CPA, (THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, April 1958) was both excellent and complete. However, if I may, I should like to supplement it with the point of view and the experience of a smaller CPA firm, let's say, one with only a single principal and a staff of from three to six assistants.

Where such firm, in addition to a diversified accounting practice, has also a diversified and difficult tax practice, it is advisable that the principal leave all the routine accounting matters, audits, and the preparation of all routine tax returns to his staff, with only his over-all supervision. The principal is thus enabled to devote most of his time and efforts to various conferences, management problems and most of all to

important tax matters, interpretation of changes in the various tax laws, and tax examinations. If the principal, through these latter activities, succeeds in proving to his clients that his personal service, knowledge, and experience are of great value to them, these clients will recognize and appreciate this fact even though they do not see as much of the principal as they see of his assistants. By reserving these important and specialized matters for himself, the principal, in fact, forces not only his own staff but also his clients to come to him for final decisions, and he thus retains a firm grip on his clientele.

Unlike the head or a senior member of a tax department in a large firm, a wise and experienced practitioner in a smaller firm does not try to study and remember all the new tax laws and all the decisions of the Internal Revenue Service and the various courts, indiscriminately. He certainly does not attempt to remember the section numbers of the Internal Revenue Code. He knows that it would be impossible for one person to master all that, and a seasoned practitioner knows from experience that all such effort is beyond the scope of the needs of his practice.

Backed by a good knowledge and background of accounting and taxation and supplemented by years of diversified practice, the experienced and ambitious practitioner, by currently reviewing and analyzing all the possible tax needs of his clients, can usually not only take care of their current needs but he can also anticipate their possible future needs. In his article, Mr. Mills rightfully points out that, "A tax man cannot properly serve his clients unless he keeps up with all tax developments currently. He cannot wait until the problem arises and then decide he can find the answer." This applied to the smaller firm could be worded as follows: A CPA who is handling the tax matters for his firm, cannot properly

serve his clients unless he is currently aware of all tax developments and masters those which specifically involve or may involve his clients or their firms.

Although the smaller CPA firms may not need as many tax services and tax guides as the larger firms, it is very important to have all the available information in your office even though you may use some tax reporters or guides infrequently or not at all. You can never know what the next day will bring and money spent on tax information and tax helps is money spent to insure your professional honor, your reputation as a tax man, and with it of course the respect and the loyalty of your clients. The smaller accounting firm should therefore have, in addition to a well chosen and modern library of professional accounting and other professional reference books, a complete tax library including loose leaf tax services and various smaller guides and books. Of course, the articles which have or might have a bearing on your practice, should be read more carefully and in detail and if necessary further studied in the larger tax services.

This tax library and the current tax readings together with sound experience and professional ambition, should suffice to furnish the tax practitioner in the smaller firm with the necessary tools for successful tax practice. Since tax examinations by the Internal Revenue Service are usually viewed by all taxpayers with anxiety and are, in their eyes, the real test of your ability in tax matters, you must apply proper psychology in your dealings with Internal Revenue Agents. I, therefore, recommend to the younger practitioners, careful preparation, restraint, patience, courtesy and cooperation. My advice to the older, more experienced practitioners is a mild sedative a few minutes before the commencement of the tax examination.

JACK GOLDNER, CPA
New York, N. Y.

Loss Carry-Forward of Subsidiary and Allocation of Purchase Price

In recent years, a number of corporations have purchased "tax-loss" companies and used their tax loss carryforwards to reduce their own Federal income taxes.

In THE WALL STREET JOURNAL, for instance, I noticed XYZ Corp. and subsidiaries report for the fiscal year ended February 28:

	1958(a)	1957
Net sales	$39,195,749	$33,254,735
Net before income taxes	1,020,840	1,004,419
Federal income taxes	— (c)	499,012
Net income	$ 1,020,840	$ 505,407

Footnotes appeared in THE WALL STREET JOURNAL:

"(a) Includes operations of ABC Corp. (a wholly-owned subsidiary) since March 1, 1957.

"(c) . . . Such losses, however (of ABC Corp.) were available for federal income tax purposes in the current fiscal year."

Should not the profits for the current year be offset at least in part by the amount paid for the net loss carryover? In acquiring ABC Corp., isn't it most probable that part of the price paid for it was expected to be recouped by applying its net loss against XYZ's profit? And where such is the case, should not the purchase price be allocated accordingly?

Among the many condensed reports I have seen in the newspapers, I have yet to see any where such allocation has been mentioned. I am rather surprised that neither the SEC nor any of the Committees of the Society have come up with any pronouncement covering this matter.

EMILE Z. BAKER, CPA
(Tait, Weller & Baker)
New York, N. Y.

Book Reviews

Montgomery's Auditing (Eighth Edition)

By Norman J. Lenhart and Philip L. Defliese. The Ronald Press Company, New York, N. Y., 1957. Pages: xi + 766; $10.00.

For nearly half a century *Montgomery's Auditing* has maintained its position as one of the authorities of the American accounting profession in the field of auditing theory and practice. A brief review of the new eighth edition will unquestionably justify the high esteem with which this book has long been regarded by both practitioners and educators alike. Here is an extensive work by practicing CPAs which has come to be regarded as an unofficial expression of the policies and practices of one of the leading national accounting firms.

Very few independent accounting firms today would care to publicize their fundamental policies and opinions in such a straightforward manner. This very fact enhances the value of such a book in the eyes of teachers who are constantly confronted with new questions at the academic level, and particularly in the eyes of the small to medium-sized practitioner, who is faced with the never-ending search for an authoritative answer to the numberless practical problems which arise daily.

The internal organization of this text follows the now familiar format of presenting the chapters under the divisions of (1) accounting principles, (2) internal control, (3) auditing procedures, and (4) statement presentation.

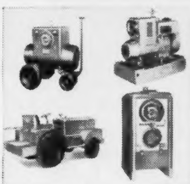
The many changes in accounting principles, auditing practices, and business and financial conditions since publication of the seventh edition in 1949, have all been included in this newest edition. Up-to-date releases by the American Institute of Certified Public Accountants are also reflected. New chapters have been added covering the subjects of "Taxes" and "Management Services." The chapter on taxes is written from an auditing standpoint and contains considerable discussion of the problems of allocation arising from application of rules relating to accelerated depreciation, amortization, consolidated returns, etc., under the 1954 Revenue Code.

The chapter on the controversial subject of management services is especially appropriate at this time and the authors express their views that while the public accountant should consider it one of his responsibilities to offer management services to his client, he should never hold himself out as an expert in any specialized field of service unless he has qualified himself as an expert in that field. The subjects of budgets and forecasts, production and cost control, office mechanization and installation of electronic equipment offer numerous opportunities for the independent accountant to serve his client in the management area.

The reader will find an excellent chapter on inventory valuation and a thorough and detailed treatment of this important and difficult topic.

Especially thought-provoking is the chapter on internal control wherein the authors advance their views on a three-way division: internal administrative control, internal accounting control and internal check. Certainly this is a fresh approach to the problem of internal control and its effect on the scope of an examination incident to the issuance of an opinion regarding the financial statements. If a valid subdivision of

NATIONAL increases flexibility and efficiency.



R. A. JONES, Controller of Hobart Bros.

HOBART manufactures a full line of Arc Welders.

NATIONAL simplifies Hobart Bros. Accounting Operation.

internal control can be made, this could have far-reaching implications to the practitioner with regard to his legal liability and professional responsibilities.

ROBERT J. DERMODY, CPA
Accounting Department, College of Business Administration, Syracuse University

Installing Electronic Data Processing Systems

By Richard G. Canning. JOHN WILEY & SONS, INC., New York, N. Y., 1957. Pages: xiii + 193; $6.00.

After a client has placed his order for an electronic data processing system, just exactly how should he go about the matter of installing it? There are two approaches: it can be "planned" or it can be "quarterbacked." Mr. Canning writes: "In many cases, the EDP installation was not planned, it was 'quarterbacked' — the problems were solved as they arose; no attempt was made to think them out ahead of time."

The function of this book is to demonstrate that the difficulties of installing a new system can be foreseen and that a realistic installation schedule can be developed and followed. The points are made through the medium of a case study of the AAA Manufacturing Company, a hypothetical company representing the composite experience of a number of companies in different industries who have installed computors.

Early in the program, this company budgeted expenditures of some $680,000 for the first four years. Subsequent experience indicated that the estimate was reasonably accurate. Clerical savings were not expected to materialize until the fourth year of the program. In fact, pay-out of the $680,000 was not expected until the sixth year.

This book covers the second, third, and fourth year of the program. It is assumed that the first year was devoted to investigation and planning, and is outside the scope of this particular volume. From the beginning of the second year to the middle of the third year was the detailed preparation period, which included such activities as organizing, programming, coding, planning the installation site, and planning the conversion phase. The equipment was actually installed near the middle of the third year. After it was installed, the activities of file clean-up, conversion, and operation, began. By the end of the book, some of the procedures were actually converted to the electronic system and in operation.

We derive from the case study a great deal of specific information about the day-to-day problems involved in organizing the computor plan and actually converting the operation from the previous method to the electronic data processing system. The insight derived should be of particular value to those accountants with clients who are installing or contemplating the installation of large-scale computors.

MICHAEL A. C. HUME, CPA
New York, N. Y.

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

HELP WANTED

Accountants-Entertainment Field, per diem or regular employment, only those experienced in the distribution of motion pictures, TV films, sheet music, records, please furnish complete details regarding the distributing company where previously employed and position held, also advise salary or per diem rate required and when available. Box 1561.

SITUATIONS WANTED

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42nd Street, N. Y. C., telephone LOngacre 4-1740.

Financial Executive, CPA, law degree, over 25 years extensive experience, public, private, presently employed assistant comptroller manufacturing company, progress blocked, seeks more challenging opportunity, excellent references, $10,000, also available week-ends to busy practitioner. Box 1539.

CPA, nine years thoroughly diversified large and small firm experience, available per diem or engagement basis. Box 1540 or OL 4-2382.

CPA, member State Society and AICPA, broad diversified background, seeks per diem assignments in N. Y. C. or lower Westchester. Box 1541.

CPA-Attorney, LLM, former revenue agent, subsequently 15 years broad tax practice, specializing estate planning, income tax, state, local taxes, research, review, opinions, examinations, protests, Appellate and other level conferences, petitions Tax Court, etc., available per diem, part-time, other suitable arrangements. Box 1551.

CPA, part-time, evenings, week-ends, Queens or N. Y. City, nine years diversified experience, automobile. HIckory 5-0629 or Box 1552.

CPA, available per diem for tax work, planning, research, will provide tax department functions for small practitioner. Box 1554.

CPA, Society member, 20 years diversified public practice, thoroughly experienced audits, taxes, reviewing, available per diem basis. Box 1555.

Per diem Work, sought by CPA, N. Y., N. J., AICPA, M.B.A., Society member, 15 years experience, age 39. Box 1556.

Long Island, per diem assignments evenings or week-ends wanted by CPA employed as financial executive, heavy national firm supervisory experience large and small clients. Box 1558.

Accountant, office manager, controller, 13 years diversified experience all phases office management, statements, taxes, credits, seeks responsible position private industry. Box 1562.

CPA, law degree, experienced in tax research, planning and review, available per diem to other accountants, $40 per day. Box 1563.

CPA, tax accountant, LLM taxation, experienced tax research, planning, protests and petitions, available per diem N. Y. C. area. Box 1564.

CPA, Phi Beta Kappa, MBA, Society member, 12 years public accounting experience, desires private accounting position. Box 1565.

CPA-Attorney, heavy top firm experience, auditing, legal, taxes, seeks position overburdened practitioner leading to partnership. Box 1568.

Office Manager, full charge bookkeeper, supervisory capacity, trial balance, balance sheet, profit and loss statement, quarterly taxes, credits, collections, etc., years of diversified experience. Box 1570.

Law Student, third year Columbia, with accounting degree from C.C.N.Y., plus completion of theory and law parts of CPA examination, desires public accounting experience affording good tax training, will work part-time until July 1959, full time thereafter. Box 1573.

CPA, eight years diversified experience, available per diem, part-time, evenings and/or Saturdays including tax season. Box 1575.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Practice Wanted, substantial terms, know-how offered overburdened or retired practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 1542.

Well Equipped CPA Firm, will purchase all or part of the practice of overburdened or retiring accountants, substantial cash or attractive retirement arrangements will be offered. Box 1543.

CPA, desires to purchase practice, New York City area, honor graduate, excellent tax and accounting background, specializes in highest type professional service to small and medium size accounts, excellent financial terms, replies held strictly confidential. Box 1544.

Have Fifth Avenue Office, without Fifth Avenue overhead, efficient personalized mail,

telephone, reception, specializing in accountants requirements, request brochure or call MUrray Hill 2-4777. 516 Fifth Avenue Mail-Telephone Service.

CPA, 34, with 14 years varied, top grade public accounting experience, seeks acquisition of accounts, practice or partnership interest. Box 1545.

CPA, diversified experience, modest clientele, free time, seeks association with overburdened or retiring practitioner. Box 1546.

CPA Firm, excellent reputation, seeks purchase of clientele grossing $5,000-$25,000, will pay substantial cash or make other desired financial arrangements, past experience assures successful take-over. Box 1547.

CPA, 33, excellent professional background, will purchase practice to $20,000 or individual quality accounts within 75 miles N. Y. C. on substantial terms. Box 1548.

CPA-Attorney, over 20 years of exceptional background, with solid N. Y. practice, seeks association or purchase of interest in CPA firm or CPA-attorney with clients in Conn., New Jersey or upper New York. Box 1549.

CPA, excellent growing practice, middle five figures, able, personable, managerial ability, desires association with practitioner having similar quality size practice, who desires retirement in few years, or has other active present interests, purpose: attractive offer whereby gradual transfer and integration, top dollar for sale and estate value is yours. Box 1550.

Practitioner, age 26, top schooling and audit background, $7,000 gross, all audit with good growth potential, seeks partner for mutual benefit. Box 1553.

Practice, individual accounts, or partnership interest, wanted by CPA, N. Y., N. J., AICPA, age 39, substantial cash available, presently grossing $11,000 with 50% free time. Box 1557.

CPA, attorney, tax man, former revenue agent and technical adviser, specializing exclusively in tax and estate planning, research, litigation, audits and returns, seeks part-time association with accounting firms in need of tax services on retainer basis. Box 1559

Former Revenue Agent, N. Y. C., CPA, 43, excellent accounting background, own practice, free time, seek proposal from accounting firm. Box 1560.

Private Office, in CPA suite, Grand Central area, receptionist and secretarial services available. Box 1566.

CPA, 35, NYSSCPA, Nassau resident, $10,000 practice, half free time to assist overburdened practitioner, view toward eventual partnership. Box 1567.

CPA, age fifty two with practice grossing approximately $15,000 seeks connection or employment with medium sized organization. Box 1569.

CPA Firm, small, established, through association will provide continuity and coverage for an individual practitioner as well as strengthen tax resources, feasible working arrangements. Box 1571.

CPA, 30, extensive diversified experience, desires position or association with overburdened practitioner leading to early partnership, will relocate. Box 1572.

Office Space, Rockefeller Center, private office and/or desk space in impressive, air-conditioned, completely equipped CPA suite, typing services optional, possibility per diem services exchange office facilities. Box 1574.

Statistical Typing, reports, tax returns, accurately and attractively typed, thoroughly checked, highly experienced, reasonable rates. Anne Steinfeld, RO 4-7539, RO 4-9675.

Part One of a Two-Part Article

Revenue Agents' Tax Audits

Some Aspects of Policy and Procedures at the District Level

By A. Frederick Olsen, CPA

So that they may better serve their clients, tax practitioners should have a clear understanding of the more important policies and procedures of the Internal Revenue Service encountered in the audit of federal income, estate, gift, and excise tax returns. Amongst the areas which are covered authoritatively in this article are the authority and duties of the revenue agent, valuation and engineering problems, and the informal conference function.

Many misleading assumptions regarding tax audit policies and procedures of the Internal Revenue Service are traceable to the injudicious acceptance of generalities by many practitioners who are unprepared by detailed factual knowledge or comprehensive experience. With that in mind, the primary purpose of this article, as its sub-title indicates, is to explain certain aspects of official policies and procedures relating to the audit of federal tax returns on the district audit level. Limitations of space must necessarily call for selectivity in the choice of subject matter to be covered in this article. Those aspects of tax audit procedure which relate primarily to internal audit management, consequently will not be covered. For the same reason, audit techniques, by which is meant those time-tested methods of inquiry and verification used by the revenue agent according to circumstances, are beyond the scope of this article. Accordingly, the topics herein selected are those with which complete familiarity is deemed to be a prerequisite to adequate client representation by the tax practitioner in his day-to-day dealings with the Internal Revenue Service on the district audit level. Except when the text indicates its application solely to income tax audits, the discussion may be assumed to apply also to estate and gift tax au-

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dits and to the audit of those various classes of excise tax returns that come under the jurisdiction of the Audit Division.

In order to better serve its intended purpose, this article is developed along functional lines, as close to normal sequence as practicable, starting with a discussion of the authority and the duties of the revenue agent. This is followed by (1) his handling of valuation and engineering problems, (2) the effect of rulings and court decisions on audit determinations on the district level, (3) the informal conference function, (4) the responsibility of the Audit Review staff, (5) post-audit review and the policy regarding reopening of closed cases, and (6) some recurring errors and omissions of tax practitioners.

The Authority and Duties of the Internal Revenue Agent

Scope of Agent's Authority

The authority of the revenue agent is derivative. Section 7803 of the Internal Revenue Code authorizes the Commissioner of Internal Revenue under delegation from the Secretary of the Treasury to employ such number of persons as he deems proper for the administration and enforcement of the internal revenue laws, and to issue all necessary directions, instructions, orders, and rules applicable to such persons. The revenue agent's specific authority is conferred upon him in the form of a personal commission issued over the name of the Commissioner of Internal Revenue by signature of the Regional Commissioner under the broad authority delegated to the latter by the Commissioner (Section 7851(b)(3)). This commission specifically authorizes the revenue agent to "perform all duties conferred upon such officers under all laws and regulations administered by the Internal Revenue Service, including the authority to investigate and to require and receive information as to all matters relating to such laws and regulations."

Section 7602 of the Code, entitled "Examination of Books and Witnesses," reads as follows:

> For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

This broad grant of investigative power follows the well-established principle that the constitutional authority given to the Congress to impose and collect taxes carries with it the power to enact appropriate provisions intended to prevent evasion or frustration of the law.

It is clear from the quoted statutory provisions that the revenue agent's investigative authority is not limited to the examination of the books and records of the taxpayer. He may also interview and, if necessary and appropriate, summon any officer or employee of the

taxpayer, or any person having possession or custody of books and records relating to the taxpayer's business, or any other proper person to produce such books and records and to give relevant testimony. The words in the statute, "books of account containing entries relating to the business" of the taxpayer, embrace the books and records of any person, such as a customer, supplier, contractor, or any other person with whom the taxpayer has had business dealings. The actual use of this broad collateral authority is generally confined to situations where tax evasion is suspected.

Procedure relating to the use, issuance and enforcement of the standard form of summons is set out in Rev. Proc. 55-6, C.B. 1955-2, 903. The vast majority of all tax examinations made by internal revenue agents is, of course, completed without recourse to a summons or collateral inquiry. Most taxpayers and third parties comply readily with every proper request of the examining officer. His commission or his citation of Section 7602 is usually sufficient to obtain the desired information. Occasionally, the revenue agent encounters a third party (such as a bank or insurance company) who is willing to furnish the desired information but requests that a summons be issued as a matter of protection. Aside from this, the issuance of a summons is resorted to only when the information is of sufficient importance to the case and cannot be obtained by other lawful means because of the reluctance of the person to furnish the desired information or to testify. The decision to issue a summons is arrived at only after careful consideration of all the circumstances of the inquiry and after evaluation of the likely importance, or the necessity to the inquiry, of the testimony to be required, or books, records or other data to be produced. Accordingly, whenever a summons is served the revenue agent is usually prepared to see the matter through. It should be stated, however, that he is under official instructions to exercise his authority with proper judgment, and that the manner in which he exercises it is an important factor in the maintenance of good public relations.

Responsibility of Agent

With authority goes responsibility. The essential purpose of the grant of authority in Section 7602 is to determine the correct tax liability of the taxpayer. This, then, is the duty of the revenue agent. This duty is, however, of a dual character. As a representative of the Internal Revenue Service he is charged with the duty of enforcing the provisions of the Code in accordance with the administrative interpretations thereof laid down in the regulations and rulings promulgated by the Commissioner of Internal Revenue. Determining the correct amount of the taxpayer's tax liability under the law is the rigorous duty and responsibility of the revenue agent. Yet, because of the duality of his duty, he is under instructions to see to it that no more is exacted from the taxpayer than is lawfully due.

The Revenue Agent as a Fact Finder

The determination of the correct tax liability requires the revenue agent to be a finder of facts whenever issues arise. It is here that the taxpayer's, or his representative's, cooperation can accomplish so much in the proper and expeditious disposition of his case. If essential facts of an issue have not been set out in the return, or if the revenue agent deems the submission of additional information necessary, it is within his function to get all the pertinent facts and the taxpayer or his representative ought to make sure that he does get them without undue delay or friction. This will enable the revenue

agent to make a determination strictly on the merits, based on full knowledge of the essential facts. The writer cannot overemphasize the importance to a case, in the audit stage, of adequate presentation of the facts whenever the revenue agent questions the taxpayer's treatment of some transaction relating to gross income, or the propriety of a particular deduction which ordinarily would need further explanation beyond a mere general statement in the tax return. Misunderstandings, friction, and other annoying experiences very often have their roots in the failure of taxpayers and their representatives to realize that most disputes arising during the tax audit are eventually decided primarily on the facts. Purely legal questions are relatively few, hence, the necessity of adequate factual presentation.

The revenue agent has been admonished by official directives as to his duty to give full consideration to all available facts when raising an issue, and to explain his position fully to the taxpayer, or the latter's representative, in the event of a difference of opinion concerning the application of the law. He can properly perform his duty only on the basis of the record as developed during his audit. Audit adjustments by the revenue agent in disregard of credible evidence adduced by the taxpayer are regarded as arbitrary and contrary to Service policy. By the same token, deductions claimed by the taxpayer which are not based upon evidence of acceptable probative value will generally be considered in that light in reaching a determination. Once the essential facts have been developed, any dispute between the revenue agent and the taxpayer concerning the correct application of the law to those facts can be made the subject of an informal conference before an impartial conferee in accordance with the procedure established for such situations as explained in a subsequent part of this article.

In multiple-issue cases the revenue agent (or local conferee) is authorized to accept a partial deficiency agreement (Form 870) in order to eliminate agreed issues from the area of disagreement. This permits the agreed deficiency to be promptly assessed and paid without the accumulation of additional interest pending eventual disposition of the unagreed issues.

Limitations on the Revenue Agent's Authority

The revenue agent is sometimes criticized for what may appear to be an insusceptible attitude toward certain hard problems involving, for example, some deduction which the taxpayer or his representative feels has in it a strong appeal to sympathetic treatment, but which turns out, after genuine research, to be either a nondescript before the law or bordering on one of the prohibited deductions (Section 261 et seq.). Illustratively, and to bring the hypothetical issue closer to routine, the problem may be that of traveling, entertainment, and sales promotion expenses of a closely held corporation, involving the possibility of income attribution to the officer-stockholders who did the spending but were indifferent to the requirement of reasonable record keeping. Here, the argument likely to be advanced by the taxpayer is that the money was spent for the benefit of the business and ought to be allowed on the basis of "equity" (a misnomer), or a fair "settlement."

It must be pointed out, however, that in dealing with such problems the revenue agent is trying to enforce rather precise statutory provisions in accordance with the Commissioner's administrative rulings and regulations. He has no authority to allow the words of the statute to be superseded by appeals to

his sympathy. To be more specific, the revenue agent has no "equitable" power; not even the Tax Court has such power. Neither does he have "settlement" authority, by which is usually meant splitting an issue, or some arbitrarily-arrived-at percentage allowance. To the oft-repeated suggestion that the rule of *Cohan* v. *Commissioner* (39 Fed. (2) 540) be applied as a basis of disposition when unsubstantiated expense deductions are questioned, it ought to be kept in mind that the *Cohan* rule cannot serve as an anodyne for the inescapable burden of first establishing the necessary factual basis. Having done that, the revenue agent is in a position to exercise his best judgment in the light of the evidence adduced by the taxpayer, making reasonable estimates where more complete substantiation is not usually to be expected.

The Revenue Agent's Concern with Realities

The legal right of a taxpayer to minimize the amount of what would otherwise be his income tax liability by means which the law permits is no longer open to question; but neither is the right of the Commissioner of Internal Revenue to prove that a particular transaction or arrangement is not what it appears to be, and that the parties thereto intended to, and actually did, enter into a different arrangement by which tax liability ought to be governed. Substance rather than form, and the question of whether what was done, apart from the tax motive, comes within the ascertainable intent of the statute—these may become the decisive criteria in judging the tax effect of some transaction or arrangement if called in question by the revenue agent.

Last year, the Mills Subcommittee of the House Ways and Means Committee issued a report listing a considerable number of what it called unintended benefits and loopholes available to taxpayers under the Internal Revenue Code. The scope of this article precludes more than the mere mention of the report. In this connection, the statutory concept of capital gains has been gradually expanded and now includes many types of income originally not thought of as other than normal income. A taxpayer's right to avail himself of statutory benefits in any proper case is, as stated, not open to question; but any devious use (or abuse) thereof to obtain unintended tax benefits presents a problem with which the Revenue Service is concerned. Accordingly, the revenue agent is required to be continually on the alert to uncover and report problems and practices which indicate abuse of statutory benefits, or tax inequities and administrative difficulties encountered in the application of the law and regulations.

Safeguarding the Collection of Taxes

While the collection of taxes is the responsibilty of the Collection Division of the District Director's office, the revenue agent is not completely exempt from participation in this responsibility. If, in the course of his audit, he detects evidence of diversion of assets by the taxpayer, and if he believes that the Collection Division will have difficulty in collecting any tax due, the agent is required by specific instructions to notify the Collection Division. If he finds transfers of property by the taxpayer, not in the ordinary course of business, material in value and without adequate consideration in money or money's worth, he is required to take appropriate steps to ascertain if any gift tax liability has been incurred. In addition, he will be required to initiate transferee proceedings without delay, if in his judgment such action is appro-

priate under the circumstances in order to protect the revenue.

Similarly, where a corporation has adopted a resolution to dissolve or to liquidate any part of its capital stock, and has filed with the District Director the return required by Section 6043 (Form 966), the revenue agent is required to extend his income tax audit to include the last return filed; to make certain that the corporation's tax liabilities (including the liability for employment and withholding taxes) have been discharged; and, if necessary, to consider the problem of transferee liability.

Valuation and Engineering Problems

Valuation Problems

The average revenue agent is usually fairly adept at unraveling complicated tax situations. But there are some things that the revenue agent is not. He is not a real estate expert, or a mortgage appraiser, or an antiquary. And even if, perchance, he may have acquired some familiarity in these fields through his professional experience, he would not qualify as an expert in the juridical sense. Yet, he is from time to time confronted with tax problems which require the services of someone qualified in these and related fields. Casualty losses occasioned by total or partial destruction of property; the theft of a valuable manuscript; the valuation of real or personal property as of a basic date for allocation and depreciation purposes, where a mixed aggregate of assets have been acquired in a single transaction; or the current fair market value as the measure of a contribution deduction of, for example, a Louis XIV carved and gilded wall mirror—these and many similar problems involve valuation determinations in arriving at the amount of allowable deductions. Estate tax examiners are constantly confronted with valuation problems in connection with the audit of estate and gift tax returns.

Because the revenue agent is generally not qualified to undertake such valuations, the larger audit divisions have a group of trained specialists in these fields to handle valuation problems in income, estate and gift tax cases whenever a valuation determination represents a relatively significant aspect of the audit. This group is generally referred to as the "Valuation Section." In situations such as those mentioned in the preceding paragraph, the examining officer will necessarily refer the issue to the valuation section for a determination of the required values. A typical and frequent example is a case where a piece of improved real estate has been acquired during the taxable year and allocation of the cost as between the land and building is necessary to determine the basis for depreciation of the building for the current and subsequent years. This is important to the taxpayer as well as to the Internal Revenue Service in disposing of the *basis* problem once and for all. In the smaller cases, where a valuation determination may not be a significant factor taxwise, the examining officer is free to assume full responsibility for the disposition of the problem without reference to the valuation section. The responsibility for determining appropriate depreciation rates rests entirely with the examining officer.

The valuation section furnishes revenue agents and estate tax examiners with written appraisals of the fair market value of real estate, mortgages, leaseholds, capital stock of real estate corporations, and personal property involved in theft losses and deductible contributions. It also makes appraisals for use in determining the allowable deduction for casualty losses. If there is

a likelihood, in any particular case, that property values used by a taxpayer may not be approved, it is the usual practice of valuation appraisers, before preparing their report, to afford the taxpayer an opportunity to substantiate his own valuation by the submission of any appraisal which may have been made for him and to bring along his own appraiser as a witness, if he so desires. The appraisal thus prepared by the valuation section constitutes the evidence upon which the examining officer makes his determination of the allowable deduction or realized gain. If the valuation is unagreed at the investigative level, it is not likely to be changed by a conferee in any subsequent informal conference without the concurrence of the revenue agent-appraiser or his supervisor, who usually attends the conference as a witness. In actual practice, it is usually recognized by both sides that valuation appraisals constitute merely opinion evidence. Consequently, such disputes are generally resolved in the informal conference when all relevant factors are given their proper consideration. Rarely do valuation issues go beyond the jurisdiction of the District Audit Division for disposition.

Casualty loss deductions seem to be a rather frequent source of dispute, particularly with respect to nonbusiness property. To a certain extent this is due to a misunderstanding by taxpayers and practitioners alike of the fundamental rules inherent in Section 165(c)(3), IRC. All too frequently it seems to be assumed that the measure of the deductible loss is the amount paid in repairing the damage. True, if the repairs do nothing more than restore the property to its condition immediately before the casualty and do not add to the value, utility, or useful life of the damaged property, such repair cost (less any insurance recovered) may be accepted as the measure of the deductible loss, and the examining officer has authority to accept it in a proper case. However, the general rule with respect to nonbusiness property is that the loss is to be measured by the difference between the fair market value of the entire property (including both land and building, in the case of residential property) immediately before the casualty and its fair market value immediately after the casualty, ascertained by acceptable appraisal, less any insurance or other compensation received in respect thereof. (*Mary F. Cary et al.*, 7 T.C.M. 724, 727.) As so computed, the loss cannot exceed the adjusted basis of the property. (G.C.M. 21013, C.B. 1939-1, 101.) This is the position of the Service and is supported by court decisions. Where the damage and the cost of restoration are substantial, the Service will in all probability require an appraisal.

Because of the importance of this subject, taxpayers and practitioners should secure a copy of Internal Revenue Service Publication No. 155 (revised January 1958) entitled "Casualty and Theft Losses," which deals with this subject extensively and in clear language. On February 3, 1955, the Service issued IR-Circular No. 55-11 which outlined the rules to be followed in computing losses due to hurricane damage. This circular was published in the C.C.H. Tax Service, Volume 5, paragraph 6174, and in Prentice-Hall 1955 Current Volume, paragraph 76742.

Another situation sometimes associated in the taxpayer's mind with casualty losses is the damage or destruction of ornamental trees on property used for residential purposes, caused by progressive deterioration as a result of disease, or fungus spread by various beetles, insects, worms, etc. The Internal Revenue Service has consistently held that a loss of this kind does not come

within the meaning of Section 165(c)(3) of the 1954 Code, or Section 23(e)(3) of the Internal Revenue Code of 1939, and is not deductible for federal income tax purposes. This position has been sustained by the courts (Rev. Rul. 57-599).

Engineering Problems

As a general rule, the revenue agent is responsible for all features in the examination of a return. However, engineering personnel are available in the Internal Revenue Service to handle special features in cases involving engineering issues. The referral of these special engineering problems to engineers is not mandatory, but is at the option of the revenue agent having responsibility for the determination of the tax liability. Accordingly, it is the policy to utilize available engineering assistance on a consultative and advisory basis in arriving at determinations of tax liability in cases involving engineering features. Some of the engineering problems for which the revenue agent may deem it desirable to request the assistance of a Revenue Service engineer are:

1. Substantial depletion deductions.
2. Depreciation deductions in excess of normal depreciation based on plant activity.
3. Extraordinary deductions for repairs which appear to the examining officer to represent major capital expenditures.
4. Large deductions for exploration costs.
5. Losses claimed as a result of alleged worthlessness of mineral value.

The revenue agent may also request the services of an engineer agent where the taxpayer relies on the use of an engineer with respect to determinations or contentions in an examination and it appears especially appropriate that the services of an engineer in the Revenue Service be obtained to advise the examining officer with respect to such determinations or contentions.

If a taxpayer, during the course of an examination, requests that the examining officer refer engineering issues to engineering personnel in the Revenue Service, such referral is within the discretion of the revenue agent. The request is not to be arbitrarily denied. In acting upon it, he is expected to exercise his best judgment, considering the nature of the problem and all the circumstances of the case. If the circumstances warrant it, the request is granted.

Whenever the revenue agent deems it desirable to request the services of an engineer he must, of course, give appropriate weight to the engineer's views. However, the fact that an engineer has been consulted and has made a report is not to be used as a basis for the examining officer, or his group supervisor, or a conferee, shifting the responsibility for finality of decision to the engineer's report. If, after considering the engineer's report and the contentions of the taxpayer, there is doubt as to the proper solution to a disputed engineering issue, the matter may be referred to the Engineering and Valuation Branch in the National Office for its advice.

The Binding Effect of Rulings and Court Decisions on the Determination of Tax Liability in the Audit Division

Under what circumstances, and to what extent, is the revenue agent or local conferee bound by rulings of the Revenue Service and court decisions in making his determination on a disputed issue which has arisen during the audit of a tax return? The question permeates the entire field of federal taxation, and the scope of the subject is broad enough

to justify extended discussion. Here, it can only be dealt with briefly.

Binding Effect of Rulings

Let us consider first the matter of "rulings." At the outset, it is desirable to have a clear understanding of the meaning of this word. The term "ruling" is officially confined to a pronouncement by the National Office as to the position of the Revenue Service with respect to the tax effect of a transaction or a set of facts specifically described therein. (Rev. Rul. 54-172, C.B. 1954-1, page 394.) Accordingly, the term "ruling" is used to describe a written statement issued by the National Office of the Revenue Service, expressing the official interpretation or policy of the Office of the Commissioner of Internal Revenue. District Directors do not issue "rulings." They do issue "determination letters" in a limited class of inquiries (Rev. Rul. 54-172, supra), but these are more in the nature of pre-audit decisions. They do not have the force and effect of National Office rulings. A determination made by a revenue agent or other district audit official in the audit of a taxpayer's return does not constitute a ruling.

For present purposes, it may be said that there are three types of rulings, namely, (1) ruling letters to taxpayers, (2) technical advisory memoranda from the National Office to district audit divisions, and (3) published rulings.

By a "ruling" letter is meant an individual letter sent to a taxpayer or his representative by the National Office in reply to a request for a statement as to the Service's position respecting the tax effect of a specified item or transaction. As such, it constitutes the basis upon which that particular transaction or item is reflected in the taxpayer's return and is binding upon the revenue agent in making his audit of that return, assuming he finds the actual facts to be substantially as presented to the Service. His duty to make such a finding is an inherent step in his audit (Section 12.02 of Rev. Rul. 54-172).

Here it must be pointed out that since the ruling was issued to a particular taxpayer it does not constitute a binding rule or precedent in any other case, related or unrelated. It may not be cited by a revenue agent or local conferee in support of his determination in any other case; nor may it be cited or relied upon by, or on behalf of, another taxpayer. Taxpayers' representatives have on occasion produced a copy of a ruling letter issued to some— usually unrelated —taxpayer in support of their position in another case then in the audit stage. This practice is unreliable. A significant factual difference would immediately put an end to the comparison. Moreover, the earlier ruling might not represent the current position of the Service; or, a later ruling or court decision may lead the revenue agent to question the correctness of the earlier ruling. However, where no such obstacles are present, the rationale of the ruling letter may be adopted in the current case in the interest of consistency and prompt disposition.

A "technical advisory memorandum" is, for all practical purposes, a ruling by the National Office in reply to a request by a field office for technical advice as to the proper treatment of an item or transaction involved in a current tax audit for which there appears to be no adequate or certain guidelines in existing regulations or published rulings. (The subject of securing technical advice and the related procedure are dealt with in a subsequent section.) Since these memorandums deal with the application of the law to specific facts and circumstances involved in a particular case, they do not constitute

a binding rule or precedent in any other case and may not be cited or referred to by field audit personnel as a basis for determination in any other case under audit. This is a matter of established policy communicated by instruction to all field personnel. The avowed purpose of the rule is to assure an independent audit determination in any other case, strictly on its own merits.

Published rulings are those which appear in the weekly Internal Revenue Bulletin. All such rulings have received the consideration and concurrence of the Chief Counsel. They are published as a matter of policy with the view of promoting uniformity in the application of the Internal Revenue Code and Regulations. They have their source, generally, in the ruling letters and technical advisory memorandums already referred to, and are so drafted as to conceal the identity of the taxpayer as well as any confidential matter. The policy governing the official publication of rulings is set out on page 2 of each Bulletin. The following quotation therefrom is pertinent at this point:

> Since each published ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, Revenue officers and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. In applying rulings and procedures published in the Bulletin, personnel of the Service and others concerned must consider the effect of subsequent legislation, regulations, court decisions, rulings and procedures.

This official cautionary note indicates the sole limitation on revenue agents and taxpayers alike on the binding effect of published rulings as a precedent in the disposition of other cases.

Section 7805(b) of the Internal Revenue Code authorizes the Commissioner to set a temporal limitation on the application of a new ruling modifying or revoking an earlier one. Where taxpayers or their tax consultants have in good faith relied upon a published ruling of general application in giving effect to a transaction or an item, and assuming the ruling would otherwise be applicable, the purpose of Section 7805(b) is to permit the revocation or modification to be applied prospectively in order to prevent detriment to taxpayers who relied upon the earlier published ruling. This follows from the Service's policy that taxpayers may rely upon published rulings in determining the rule governing their own transactions. Of course, a change in the law carries with it the presumption of knowledge thereof by all concerned, and the stated policy is obviously inapplicable (Section 12.06 of Rev. Rul. 54-172, supra).

Court Decisions

The early resolution of tax disputes by administrative processes rather than by the costly and uncertain road of litigation is a wish often expressed over the years by Treasury officials and by taxpayers. However, time has not witnessed any decrease in civil tax litigation; nor is it likely to do so in the foreseeable future in view of the increasing complexities of the tax law and the magnetic influence of various unintended benefits offered by the Internal Revenue Code. Viewing the matter philosophically, we have come to believe, whether we like it or not, that the expense and annoyance of litigation have become a part of the never-ending process of trying to find right answers to seemingly hard tax problems. There is nothing particularly original in that statement. The late Justice Cardozo said, many years ago, in one of his famous lectures: "The law stands indicted for uncertainty and the names of weighty witnesses are endorsed upon the bill."

Whether a particular Tax Court decision, adverse to the Government's contentions, is to be followed by a revenue

agent (or local conferee) in other cases involving a similar issue, has always been a troublesome area in tax administration. The mere fact, for example, that the Tax Court's decision in a given case is adverse to the position taken by the Revenue Service in the deficiency notice does not *per se* preclude its use as a guideline for other cases. The criteria lie elsewhere. Where the decided issue is predominantly factual in nature and the essential facts were not presented to the Service before it made its determination, the decision of the court predicated on the facts, and involving no dispute as to the application of the law, is obviously of only passing significance as a precedent.

It is the policy of the Service to announce the Commissioner's acquiescence or nonacquiescence in Tax Court decisions in the Internal Revenue Bulletin and to do so without undue delay. His announced acquiescence in a decision which reversed his deficiency determination means that the case may be cited as a basis for disposition of any other case involving the same or similar issue, provided that the facts and circumstances are substantially the same as in the cited case. Consideration must, of course, be given to the effect of new legislation, later regulations, rulings, and subsequent court decisions.

Where the Commissioner has announced his nonacquiescence and a petition for review is filed in the applicable circuit court of appeals, the revenue agent is, of course, precluded from citing or relying upon the Tax Court decision. In rare instances, the Commissioner has announced his nonacquiescence and yet has not sought a review of the Tax Court's decison. Here again, the revenue agent or conferee is precluded from adopting the Tax Court decision in any pending case. In this limited class of cases there is usually a very good reason for not seeking review of the Tax Court decision. For example, the factual record may not be propitious for a reversal; or, it may be that a similar issue is involved in a refund suit in a district court or in the Court of Claims and a different answer might emerge. In any event, the nonacquiescence constitutes notice that the Service is not abandoning the position it unsuccessfully contended for in the Tax Court.

Cases originating in a United States District Court or the Court of Claims come under the immediate jurisdiction of the Department of Justice. All tax cases in the Court of Claims are based on rejected refund claims. The same is true with respect to the bulk of the civil tax cases brought in the district courts; and here many of the cases are tried before a jury and are, therefore, unaccompanied by any "opinion" of the court. Only those cases coming out of the district courts or the Court of Claims which are published in the Internal Revenue Bulletins may be freely relied upon by district audit personnel in the disposition of other cases involving a similar issue and substantially the same factual basis. However, procedure exists whereby the position of the Service with respect to other decisions of these courts, not published in the Bulletin, can be determined by a revenue agent or conferee if necessary to the disposition at the district level of any pending case involving a similar issue.

Decisions of the circuit courts of appeals affirming decisions of the Tax Court which had reversed the Commissioner's deficiency determinations are, if of general importance, published in the Internal Revenue Bulletin when the Service accepts a circuit court's decision as the correct application of the law involved. Such published decisions may then be followed in other cases involving the same issue. Here, also, procedure exists whereby district audit personnel may ascertain the Service's position with respect to unfavorable circuit court

decisions not published in the Bulletin. However, it should be pointed out in this connection that the Service sometimes refuses to accept and follow adverse decisions of two or more courts of appeals on a particular issue. When this occurs, it generally indicates that the Government intends to continue to litigate the issue, with the expectation of eventual Supreme Court review. In such situations, district audit personnel have no choice but to adhere to the Service's position in disposing of pending cases, or to place them in suspense until the issue is finally disposed of, provided written consents are secured extending the statutory period of limitation on assessment.

Obtaining Technical Advice from the National Office

A "technical advisory memorandum" is a ruling by the National Office in reply to a request by a District Director for technical advice as to the proper treatment of an item or transaction for which there appears to be no definite precedent. Generally, the request has its origin in a current audit.

As a matter of official policy, the Service is dedicated to the purpose of achieving the greatest degree of uniformity in technical audit matters throughout all the districts. And this policy applies equally to isolated transactions and to technical matters of general interest to all taxpayers. Complaints about inconsistency among districts in the treatment of substantially similar technical problems arising during audit are a matter of concern to the Service, which the technical advisory function is intended to avoid. With this purpose in view, District Directors and their audit personnel have been encouraged, through directives, to request technical advice on issues which cannot be resolved by the field with certainty and consistency on the basis of the provisions of the Internal Revenue Code, regulations, or rulings, or other clearly established precedents. This long-established policy is reflected in Section 8.02 of Revenue Ruling 54-172, already referred to. Since the National Office will not issue rulings to taxpayers on the treatment of any item or transaction reflected in a return already filed (to do so would be to enter the field of audit operations), the technical advisory procedure serves a somewhat similar purpose.

When a District Audit Division decides to request technical advice from the National Office, a memorandum is prepared setting forth all of the pertinent facts, accompanied by any relevant documents and other evidence or information necessary to clearly establish the facts in the case. The taxpayer's contention, including any brief or memorandum of law he may have submitted, and the position of the Audit Division are also submitted. Established procedure provides that the taxpayer or his authorized representative must be notified that the case is being referred to the National Office. The procedure also provides that the taxpayer must be afforded a conference in Washington before any adverse decision is rendered. Thus, the taxpayer is assured of a hearing in the National Office before an issue is decided contrary to his views. These rules are strictly enforced.

While such referrals to the National Office are most often initiated by the District Audit Division, a taxpayer has the right to make such a request, and if the request is a reasonable one, considering the nature of the issue, it is usually honored. This is the practice of the New York Region. The insistence that the taxpayer's request for such referral be reasonable is intended solely to prevent needless delay in the disposition of cases where the correct answer to an unagreed issue is readily obtainable from rulings or regulations, or such other published material as taxpayers and practitioners are accustomed to consult when issues arise.

Techniques in Allocating Costs to Functions in Charitable Organizations

By Samuel L. Steinwurtzel, CPA

Modern charity's need for functional costing calls for the development of suitable allocation techniques. This article discusses the procedures to be applied in arriving at functional costs with special emphasis on the utilization of time sheets and methods of time distribution.

The current trend toward wider use of functional costing in charitable organizations makes it imperative that care be given to methods of developing such costs. The processing of functional costs, known as functionalizing, entails the classification of expenses from their natural form (e.g., salaries, rent, telephone, and materials) into categories that describe the operations of an organization (e.g., education, community service, and fund-raising). The certified public accountant's concern with the validity in recording a charity's functional costs is two-fold: (1) He has a basic responsibility for the propriety of his client's accounting system, and (2) he must assure himself that his opinion on the client's financial statements is supportable. The core of accurate functional costing lies in the reliability of the techniques of allocation.

Unfortunately, much of the functional costing in charities is of questionable validity, largely because of the failure to use appropriate techniques of allocation. As a result, the distribution of costs from their natural form to functional categories may be faulty. Distributions are sometimes based either on "guesstimates" or on arbitrary determinations by a charity management.

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Functionalizing Costs in the Books of Account

Several steps should be taken to improve allocation procedures. To begin with, cost distributions should be incorporated in the accounting system and records. If feasible, allocations to functions can originate in the organization's journals (e.g., salaries, in the payroll journal) after distribution factors have been established. Postings are then made to columnar-style expense accounts in the general ledger. The ledger account itself is generally of the natural kind while its columns set forth the functional costs. As an alternative, allocations to functions may be developed directly in the columns of the general ledger expense accounts, thus bypassing the journals. Some organizations use a reverse procedure by establishing ledger

accounts of the functional rather than the natural type and distributions are then made to columns of natural categories.

The Selection of Allocation Techniques

In dealing with the question of allocation, the charitable organization should carefully analyze its operations. Selection of techniques depends to some extent on the style of the organization. Charities that departmentalize functions organizationally and physically generally will choose methods of allocation that differ from those suitable for organizations that spread functional assignments over the entire employee staff and limit functionalizing to accounting and reports.

Particularly valuable as a start is the expense list of the charity's chart of accounts in natural form. The expenses should be carefully examined and appropriate methods of allocation selected for each account. The accountant should weigh loss of accuracy in distribution with savings in time and money.

Direct expenses present no problem since they are specifically incurred for a particular function and it is rather a simple matter to allocate such items directly to the appropriate function. Joint costs (also known as indirect costs) representing costs that are incurred for two or more functions, require distribution over the functions that have benefited from them. Expenses such as salaries and related costs should be apportioned on the basis of performance while other costs of a joint nature lend themselves to allocation by quantitative formula or selective device.

As indicated previously, the operational pattern generally determines the appropriateness of the method of cost distribution. The basic guiding principle in making the selection is that the allocation to the function should fairly reflect the cost applicable to that function. In dealing with the question of salaries, the allocation technique should produce the amount of salary cost of the function. The salary of an employee whose activity is confined to a single function is, of course, a direct charge. On the other hand, employees who perform services for more than one function need to have their salaries apportioned. This question brings us to the matter of a time record.

Time Sheets for Allocating Salaries

If an employee's time is apportioned among functions in advance on a well-defined basis and the apportionment is scrupulously adhered to in actual practice, then the predetermined allocation may be utilized in the salary distribution and a current time record of the employee's service will not be necessary. If, however, the worker's assignments are of such great variety that a predetermined time allocation schedule (or even a subsequent time analysis) does not accurately reflect the employee's actual activity performance, then a time sheet of some kind must be kept. Time sheets may cover operations over a daily, weekly, or monthly period, depending on the complexity in accounting for the functions performed. Of course, monthly or weekly time records are preferable, in that order, because of the limited number of entries required. Either may suffice if the worker's assignments uniformly cover long periods of time. On the other hand, if the work is such that the employee operates in several functions within relatively short periods of time, it may be necessary to use a daily form. The description that follows discusses this type of record. Principles and techniques apply similarly to the weekly and monthly forms.

Daily Time Sheet

The purpose of the employee's daily time sheet is to develop percentages that may be applied to joint costs of salaries for the distribution of such costs to functions. At the same time, these percentages may be utilized for apportionment of joint costs of employees' benefits (consisting of social security taxes, health insurance, workmen's compensation and other such items) to functions.

Many agencies with multifunction staffs have operated for years without having to prepare detailed time records and it is only recent influences and developments that now compel their use. Time sheets need not be complex. The problem seems large because it is difficult for the employee to determine, from a day's work of considerable variety and overlapping of activity, the amount of time that properly applies to each function. Some education of staff is therefore necessary. In enlisting employees' cooperation it should be pointed out that allocations on time sheets in many instances are necessarily estimates and that not all areas of accounting are susceptible to scientific exactness. The allocations should be made as simple as possible.

A suitable time chart should be devised. A style now in use by county non-profit agencies operating in the tuberculosis and heart fields covers one month's operations. The work of these organizations is mainly educational and organizational in nature and salaries are the chief item of cost. The vertical columns of the daily time sheet are headed by days of the month while the horizontal lines show the functions of work of the organization. All professional employees are required to keep a daily record of performance. Entries are made for time spent in multiples of an hour. Fractions of an hour are disregarded in order to simplify the recording. The employee prepares the daily time record at the end of each day for the current day's work. In deciding upon the appropriate entry for time spent, the employee is guided by the primary purpose of the work performed. At the end of the month, all the hours are totalled across and cross-footed. Percentages are computed for each function by dividing each function's hours by the grand total of the month. These percentages become the distribution factors in allocating the employee's salary (and related benefits) to functions.

In many instances it may not be necessary for the clerical staff to keep time sheets. Rather, the salary of the professional's secretary or clerical assistant is distributed over the functions by the same percentage as the professional, provided that the work of this employee is supportive in nature to the professional's assignments. It would be almost impossible for a secretary, being somewhat removed from the actual program, to maintain time records, but it is reasonable to assume generally that the secretary's work corresponds functionally to that of the professional.

The Use of Summarized Percentages of Time Distributions

Generally, the highest degree of accuracy in the distribution of joint costs is attained by developing the most appropriate method of allocation to functions for each natural expense. This procedure is recommended for organizations where expense amounts are material and the operations lend themselves to refined allocation techniques because of the organizational and physical division of functions. At times, however, such fine analysis, especially in smaller organizations or in dealing with insignificant amounts of expense, is more costly in time and effort than the result

is worth. Other means of a practical nature need to be determined.

In this connection, an alternative method that is particularly useful in allocating joint costs that bear a relationship to employee activity is that of summarized percentages of time distributions (hereafter referred to as summary distribution percentages). These percentages are obtained by collecting all time sheet distributions (discussed in the previous section) of employees to functions for a given period on a distribution sheet. Final percentages are arrived at by determining the relationship of each function's total hours to total hours of work of the agency.

Summary distribution percentages are useful for smaller organizations especially where other methods are not practicable in distributing such items as rent, telephone other than tolls, stationery and supplies, travel, and liability insurance, provided that a relationship to employee activity exists. Care must be exercised when using this method that distributions are equitable and do not cause distortion of cost.

Quantitative Measuring Formulas

Quantitative measuring formulas serve in particular instances as devices for distributing certain joint costs. Thus, rent (including light, heat, repairs, and insurance), or building operation if the structure is owned by the agency, lends itself to quantitative measurement by allocation on the basis of space used by each function. The total rental cost is reduced to a square-foot rate. The number of square feet occupied by each function is measured and then applied against the footage rate, thus producing the rental cost of each function.

It may not be possible to utilize this device in cases where employees perform several functions, as is usually found in smaller organizations or in certain types of operation. Here it may be necessary to resort to a rental distribution to functions on the basis of the summary distribution percentages as previously suggested.

Another quantitative method of allocation is that employed in distributing telephone expense. Toll calls are in the nature of direct expense but local service and related costs are of a joint type. These latter charges are lumped together. A single telephone extension cost is obtained by dividing the number of extensions into the total cost. The expense is then distributed on the basis of the number of extensions used by each function. Here again, in some organizations, an extension may be used for more than one function and it is probably simpler to allocate the joint cost portion of the telephone bill on the basis of summary distribution percentages.

Quantitative distribution methods are also useful in apportioning costs of pamphlets, annual reports, and publications that contain material pertinent to the operations of more than one function. The cost per page of each pamphlet is computed and then applied to the number of pages devoted to each function.

Aggregating Expenses of Like Distribution

It is desirable in appropriate situations to aggregate into groups certain natural expenses that are distributable to similar functions on the same basis. For example, rent, heat, light, and liability insurance are costs of space and therefore should be distributed equitably to functions that occupy space. It follows that these expenses may be collected into one account and then distributed as a single item, perhaps labelled as space charges or some other suitable title. Annuities, social security, group

insurance, hospitalization and like expenses also lend themselves to aggregation into one account. Distribution to functions would then be made by a suitable method for one collective expense appropriately identified, possibly as payroll items.

Service Functions

Many larger agencies maintain operational units that render service to the functions of the organization. Costs of these units (referred to as service functions) are collected and also distributed to functions, in a great number of cases, by appropriate methods. Business management is an example of a service function. Costs may consist of bookkeeping, purchasing of supplies, telephone operation and reception, duplicating, mail handling, messenger service, personnel work and the like. The service function serves as a cost center and distributions are made to functions that receive service. First, of course, the service function must absorb all distributive costs such as space charges, telephone and other allocable expenses. Then, each of its activities should be analyzed from the standpoint of services rendered.

Several methods of distribution may be required, depending on the activity. For example, in bookkeeping, such phases as receiving and acknowledging contributions, deposit of cash, and the keeping of contribution records, are chargeable to fund-raising, while operations consisting of payroll preparation and disbursements may bear a relationship to the activity of all functions. These latter items may be distributed, if equitable, by the use of summary distribution percentages. In other cases, time tests based on service given may be necessary in order to determine the appropriate amount to be apportioned. Items of a general nature that do not relate to functions but rather are part of overall management, are charged to administration.

Appropriate portions of record-keeping costs are allocated to all functions on the ground that record keeping is as essential in operating program functions as it is in conducting fund-raising and also because this procedure produces a more complete cost of functions. This method of costing is somewhat similar to that employed in distribution cost analysis in commercial accounting.

Some charities do not distribute the cost of service functions on the theory that such allocations cannot be made with accuracy. Since there are variations in practice in this regard, it seems advisable that charities' reports should indicate whether service functions have been distributed.

Conclusion

Considerable pressure is being placed currently on the charitable organization to improve the accuracy of its functional costs. There are indications which suggest that this pressure will continue with even greater emphasis. The bridge to accurate functional costing is techniques of allocation. The certified public accountant and charity management need to examine carefully present methods of processing costs to determine whether responsibilities are being fully met to the public and government in terms of sound bases for financial reporting.

Travel and Entertainment Expenses

By RICHARD S. HELSTEIN, CPA

This article discusses the basic problems resulting from the changes in policy of the Internal Revenue Service in dealing with travel and entertainment expenses. The substantive background of the issues is outlined and this is followed by a consideration of recent developments including an exposition of the new regulations.

The Problem

It is doubtful that there exists an accountant in practice today who is not overly familiar with the litany: "But I know I spent more than that on travel and entertainment . . . You can't get bills for everything . . . I know what entertaining is necessary for my business . . . Who says I can't deduct it?" And within the last few years a new chant has been added, a most significant one: "But I always used to . . . ." It is true that "he always used to," but practices which, though never condoned, were never too strongly attacked in the past, are currently subject to severe penalties.

During the past four years there has been a distinct change in the policy of the Internal Revenue Service in dealing with travel and entertaining expenses. This change from what might be characterized as an "easy-going live and let live" policy to the present "get tough" policy is due to a perfectly understandable effort on the Treasury's part to protect the revenue and to correct abuses which have grown to unreasonable proportions. With the increasing complexity of the tax laws and the efforts of Congress to plug loopholes which acted to favor one taxpayer as against another, the simple device available to officers and stockholders (particularly of, but not limited to, closely held corporations) of obtaining tax-free benefits through travel and entertaining expense accounts, was an obvious answer.

As the practice grew beyond the bounds of reasonableness despite repeated warnings from Washington, it became necessary for the Service to crack down. Examining agents found reports being returned from the review section because of too generous allowances of business expenses. Intra-departmental instructions were issued which severely circumscribed the discretion allowed the agent, and which culminated in taxing to the individual the portion of expense disallowed to the corporation which cannot be proved as

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not having inured to the personal benefit of the employee.

As a result, accountants are faced with the problems of making the client pay far more attention to obtaining and preserving substantiation of his expenses; of eliminating expenses from which the individual obtains personal benefit; and, in some cases, even of changing the clients' basic business policies.

It is well to bear in mind, however, that the law has not changed; only the method and extent of its enforcement has changed.

The Law

Since "deductions are a matter of legislative grace," [1] and do not turn on general equitable considerations, it is elementary that the first consideration is the intent and meaning of the statutory provision for the allowance of business expenses as deductions. All revenue acts have provided for the allowance of ordinary and necessary expenses paid or incurred during the taxable year in connection with the carrying-on of a trade or business[2].

Section 162(a) IRC 1954 (which is substantially the same as Section 23(a) IRC 1939) provides:

"There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *"

The above statement is deceptively simple. Yet two phrases of the above quotation have given rise to as much confusion and litigation as any others in the tax law.

"Ordinary and Necessary"

The first is: "ordinary and necessary." It is conjunctive. Thus, expense might be *ordinary,* but it must also be *necessary* to the conduct of a trade or business[3]. The reverse is also true[4]. The term "ordinary," as it has been negatively defined by the Supreme Court, "does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often[5]." For example, counsel fees in a lawsuit may be ordinary and necessary though non-recurrent[6]. An expense will ordinarily be considered "necessary" if the expenditure is appropriate and helpful in developing and maintaining the taxpayer's business [7] provided it is not capital in nature[8],

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1. *New Colonial Ice Co., Inc.* v. *Helvering* (1933), 292 U.S. 435.

2. R.A. 1913—Sec. II(B) and Sec. II(G)(b); R.A. 1916—Sec. 5(a) and 12(a); R.A. 1918, R.A. 1921, R.A. 1924, R.A. 1926—Secs. 214(a)(1) and 234(a)(1); R.A. 1928, R.A. 1932, R.A. 1934, R.A. 1936, R.A. 1938, IRC 1939—Sec. 23(a); IRC 1954—Sec. 162. Commencing in 1942, provision was made for deduction of certain "non-business" expenses (IRC 1939—Sec. 23(a)(2); IRC 1954—Sec. 212).

3. *Dannemiller,* TC Memo Op. 1958-107.

4. See, for example *Welch* v. *Helvering* (1933), 290 U.S. 111; *Giurlani & Bro.* v. *Com.* (CA-9, 1941), 119 F(2d) 852; *Barbour Coal Co.* v. *Com.* (CA-10, 1934), 74 F(2d) 163, cert. den. 295 U.S. 731. See discussion in 4 *Mertens* (1954 ed.) Sec. 25.09 and footnotes thereto. See *Louis Greenspon,* 23 TC 138, affd (CA-8, 1956) 229 F(2d) 946.

5. *Welch* v. *Helvering, supra.*

6. *Com.* v. *Peoples Pittsburgh Trust Co.* (CA-3, 1932), 60 F(2d) 187; but where the benefit is personal, they are not "business expenses," *Kornhauser* v. *U.S.* (1928), 290 U.S. 111.

7. 4 *Mertens* Sec. 25.09.

8. *H. S. Crocker Co., Inc.* (1929), 15 BTA 175, setting forth the distinction at p. 182; Sec. 263, IRC 1954; also cost of acquiring good will, defending title, obtaining patents, etc.

ultra vires[9], or against public policy[10]. "It has been said that the statutory words 'ordinary and necessary' expenses mean those expenses which economically are an integral part of a business, whether it be lawful or unlawful"[11].

Incurred in Trade or Business

The second requirement, that the expense be incurred in the carrying-on of a trade or business[12], is equally bothersome. Although the phrase "trade or business" appears in many sections of the Code, it has never been defined in the regulations. Certainly, however, it carries the connotation of continuous activity in a certain field rather than sporadic or isolated transactions[13]. The term "trade or business" is not limited to ordinary industrial or commercial activities but includes professions, gambling, the arts, and, in effect, acting as the employee of a corporation[14].

Reimbursement of Expenses

In ordinary business practice, it has become standard and necessary procedure for employees to advance certain types of expenses on behalf of the business. In some cases, the employee is reimbursed by the employer upon submission of a voucher; in some cases, the employee is paid sufficient remuneration so that he is required to bear the expense himself; and in other cases, the employee is paid a periodic allowance to cover his disbursements. In such situations, where the amounts are ordinary and necessary and reasonable[15], the amounts of the reimbursement or remuneration to the employee are allowable as deductions to the employer.

In situations where the employee's disbursements are less than the amounts received from the employer, the excess receipts constitute income to the em-

9. *National Bank of Skowhegan, Me.* (1937), 35 BTA 876.

10. *Harden Mortgage Loan Co.* v. *Com.* (CA-10, 1943), 137 F(2d) 432, cert. den. 320 U.S. 791; *Rugel* v. *Com.* (CA-8, 1942), 127 F(2d) 393; *Pittsburgh Milk Co.* (1956), 26 TC 707. But *cf Lilly* v. *Com.* (1952), 343 U.S. 90, where payments to eye doctors by opticians are "ordinary" because they are a trade practice and necessary to maintain and establish the taxpayer's business.

11. Pock. supp. to 4 *Mertens* Sec. 25.09, p. 92, N. 74; *Com.* v. *Doyle* (CA-7, 1956), 231 F(2d) 635; *Sullivan* v. *Com.* (1958), ______ U.S. ______ affg. CA-7, 241 F(2d) 46.

12. The mere "necessity" of an expense does not ensure its deductibility. Personal expenses can also be necessary. *Com.* v. *Doak* (CA-4, 1956), 234 F(2d) 704.

13. GCM 6630, VIII-2 CB 179; Rev. Rul. 58-112, IRB 1958-12, 10; Rev. Rul. 55-431, 1955-2 CB 312; *C. Perry Snell* v. *Com.* (CA-5, 1938), 97 F(2d) 891, where the Court said the word *business,* "notwithstanding disguise in spelling and pronunciation means busyness;" *W. T. Thrift Sr.,* 15 TC 366. But see 4 *Mertens* Sec. 25.08 where it is stated: "Certain objective criteria may not, however, be ignored in arriving at a determination of what constitutes a 'trade or business' when the issue of deductibility of a claimed business expense is involved. On the one hand, continuity, constant repetition and regularity of activities, as contrasted with isolated or occasional action, are not in themselves sufficient to constitute the carrying on of a 'trade or business.' Hence, strictly investment activities may not constitute a 'trade or business,' irrespective of the quantity or frequency of the investments. On the other hand, under other circumstances, the taxpayer may be held to be carrying on a 'trade or business' even though he is not regularly or continuously engaged in the particular activities."

14. Rev. Rul. 57-502, 1957-2 CB 118 discussed in NYCPA, Jan. 1958, p. 72; *A. Jergens* (1952), 17 TC 806; *Harder,* TC Memo 1958-97. See Sec. 7701(a)(26), IRC 1954.

15. Although the Code does not use the term "reasonable," it has been held that "reasonable" is "inherent in ordinary and necessary." *Com.* v. *Lincoln Elec. Co.* (CA-6, 1949), 176 F(2d) 815. It is now required by Regs. Sec. 1.162-2.

ployee. Where the employee has expended more than he has received from his employer, the excess constitutes a deduction by him[16]. The full expenses of an employee on an allowance or of an employee who is not reimbursed are allowable deductions where such expenditures are necessary in order for him to hold his job[17].

Certain of these expenses are deductible in computing adjusted gross income including: reimbursed expenses, expenses for travel away from home, transportation expenses paid in connection with the taxpayer's performance of services as an employee, and deductions allowable to outside salesmen[18]. All others are deductible from adjusted gross income. The significance of the distinction lies in the effect upon the medical deduction [19] and the deduction for contributions [20] (which are computed with reference to adjusted gross income), or in cases where the optional standard deduction [21] is substituted for itemized deductions from gross income[22].

Developments and Doctrines

The Cohan Doctrine

"Under a rigid and inflexible interpretation or application of the doctrine that deductions are a matter of legislative grace, a taxpayer would in every case be denied a deduction for otherwise allowable business expenses where there was a failure of strict proof on his part"[23]. This would prove fatal in almost every case since complete substantiation, such as a bill or receipt, is not available for many types of expenditure (e.g., taxi fares, tips, bar bills, and meals in most restaurants where no charge account is maintained).

Out of this situation arose the "Cohan Doctrine." There is little doubt that George M. Cohan's fame in the tax world equals his reputation in the world of the theater. In 1930 the Court of Appeals for the Second Circuit held that where it was clear that expenditures were incurred and paid by Mr. Cohan, even though he had no substantiation therefor, an approximation should be made, even though it bear heavily against the taxpayer[24]. Although this decision dealt with travel and entertainment expense, it has been extended to cover business expenses generally.

It should be noted that in the *Cohan* case, the Commissioner allowed nothing for claimed expenses on the sole ground that the precise amount had not been adequately proved. The Tax Court has distinguished from this the situation where the Commissioner had made some allowance (presumably under the Cohan doctrine) which the taxpayer claims as insufficient[25]. In such a situation, the court implies that the taxpayer must sustain the burden of proof in order to increase the amount allowed. And in a recent case, the Fifth Circuit held that

16. Regs. Sec. 1.162-17.
17. See Rev. Rul. 57-502, *supra*, and cases cited therein.
18. Sec. 62(2), IRC 1954.
19. Sec. 213(a) and (b), IRC 1954.
20. Sec. 170(b)(1), IRC 1954.
21. Sec. 141, IRC 1954.
22. Regs. Sec. 1.141-1.
23. 4 *Mertens*, Sec. 25.04, pp. 9 and 10.
24. *Cohan* v. *Com.* (CA-2, 1930), 39 F(2d) 540.
25. *Frieda Hempel*, TC Memo Op., 10/30/52.

where no evidence was submitted, the lower court was justified in ignoring the Cohan doctrine[26]. However, there is the implication that this may be due to the fact that this particular case arose as a claim for refund.

The Cohan doctrine has been recognized specifically by the Internal Revenue Service in Revenue Ruling 54-195[27], in which Internal Revenue officers are instructed to make approximations of unsubstantiated expenses, where possible, if a proper basis exists. These instructions were reiterated in Revenue Ruling 54-497[28], which, however, stated that it is incumbent upon the taxpayer to provide sufficient records in connection with the claimed expenses to provide a basis for an educated approximation.

Other Court-Inspired Principles

One of the important early developments was the requirement that the taxpayer *prove* that the purpose of the expenditures was primarily for business rather than social or personal, and that the business served by the taxpayer benefited or was intended to benefit therefrom. The Tax Court said, "In general, membership in social, political or fraternal organizations is [not] helpful in obtaining clients through contacts made thereby . . .," and that therefore the taxpayer must show the business benefit received[29]. This "personal benefit" doctrine, cited in so many cases[30] that it has become almost axiomatic, is a basis for many developments.

One of those which may have far reaching effects is the *Sutter* case[31]. Since personal expenses are not deductible, the Court disallowed a portion of Sutter's entertaining expense because it would have been incurred even if the taxpayer were not entertaining. Thus, for example, that portion of the expenditure equivalent to what the taxpayer normally spent for lunch was not deductible. This principle can raise many problems through its extension[32]. For example, would it be necessary to prove that the taxpayer, who takes a customer to theater, would ordinarily not go to that show—or to the theater at all?

In a more recent case[33], which cited and followed Sutter, a taxpayer who ate at his club every day, although he joined it for business reasons, could not deduct the cost of his own meals when he entertained clients there since they did not exceed what he ordinarily spent for lunch. Further, only half of his club expenses were allowed.

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26. *W. H. Williams, Sr. et al* v. *U. S.* (CA-5, 1957), 245 F(2d) 559.

27. 1954-1 CB 47, 48.

28. 1954-2 CB 75.

29. *Louis Boehm* (1937), 35 BTA 1106, but *cf Estate of Nottingham*, TC Memo Op., 1956-281, where depreciation was allowed on bar and rumpus room used to entertain customers in taxpayer's home.

30. See, e.g., *Lellyett & Rogers, Inc.*, TC Memo Op., 1946; *Schulz* (1951), 16 TC 401; *Armstrong, et al.*, TC Memo Op., 1947; *Curry*, TC Memo Op., 1951; *Miggins*, TC Memo Op., 1949.

31. *Richard A. Sutter* (1953), 21 TC 170.

32. See discussion in Hemmings, Technical Rules Underlying Current Furor Over Deductibility of T & E Expenses, *Journal of Taxation*, January 1958, p. 3.

33. *John W. Scott*, TC Memo, 1956-274.

This year a further extension was made[34]. Where the officer of a corporation entertained customers and prospective customers at his home and outside, and, to complete a party, also invited personal friends, only that portion of the expenditure applicable to the customers was deductible.

Because of the "personal benefit" doctrine, there have been promulgated a series of revenue rulings and intra-departmental rulings which have culminated in the present policy of the Internal Revenue Service which results in "double taxation."

The Commissioner's Position

The high tax rates which came into effect during World War II provided a new stimulus to the expense account. In addition to other advantages of adopting the corporate form during that era, was the gain in obtaining a deduction on the corporation tax return for reimbursements to employees, which, in most cases, was not accounted for by the individual recipients. The abuses in this direction led to an "expense account" economy, and indeed, even today there seems to exist the belief that the expense advance can be used to effect "fringe benefits" to the employee whose tax brackets minimize the advantages of increases in salary which are fully taxable[35].

Naturally, the Internal Revenue Service was aware of the situation and the number of reported cases bears not so mute evidence to its attempts to correct the abuses prevalent. The field agents, however, found the situation a most difficult one, and, as is self-evident, were confronted with the Hobson's choice of sacrificing productivity or arriving at compromise settlements under the Cohan principle (except that, in order to get an "agreed case," it was often necessary, in applying the Cohan doctrine, to lean heavily against the government instead of the taxpayer). This state of affairs inevitably led to further evil. The taxpayer, realizing that some disallowance was inevitable, sometimes merely increased his estimate of the amount of unsubstantiated expenses to cover the expected disallowance.

Revenue Rulings

Shortly before the enactment of the 1954 Code, the Commissioner issued a ruling intended clearly to set forth his position both to the taxpayer and the examining agent[36]. The second paragraph unequivocally put the taxpayer on notice that the Commissioner was fully aware that the problem arose, not merely as an error of law, but that taxpayers claimed business deductions which included non-deductible personal, living and family expenses[37], as well as "fictitious deductions" and "excessive claims" with "willful intent to defraud[38]." Aside from the foregoing, however, the ruling shed little new light on the problem. It gave guidance in the application of the Cohan doctrine in rather broad terms, and stated that it was not the policy of the Service to allow percentage or similar settlements.

This was followed by Revenue Ruling

34. *A. C. Engineering Corp.*, TC Memo, 1958-147.

35. See discussion in Andrew C. Bailey, "Compensation with The Fringe on Top," 16 N.Y.U. Institute on Federal Taxation, pp. 275, *et seq.*

36. Rev. Rul. 54-195, 1954-1 CB 47, originally issued as I.R. Mim 54-92 on May 25, 1954.

37. Sec. 262, IRC 1954.

38. That this was not an idle threat or mere bluff is evident in the fact that the Commissioner has asserted fraud, and won, based solely on such excessive and fictitious claims. See *Frank Fehr Brewing Co.*, D.C. Kentucky, 3/5/58 (______ F. Supp. ______).

54-497 [39] which discussed travel expenses with particular emphasis on the definition of "away from home." However, this discussion, aside from defining "away from home," added nothing to the resolution of the problem of how to handle unsubstantiated deductions.

The Commissioner's position on another phase of the problem was published in a ruling covering the deductibility of expenses for a wife accompanying her husband on a business trip[40]. But although the ruling provided that the deduction of the wife's expenses would not be allowed unless the taxpayer sustained the burden of proof that her presence was necessary and served a bona fide business purpose, it was couched in such broad terms as to be of little practical value. A much more definitive position on this subject was promulgated early in 1956[41]. This ruling provided specific rules as to when a wife's expenses are deductible. While these rules do not particularly help with the problem of substantiation, they do delineate when a wife's presence "has a business purpose." For example, the ruling states that the performance of incidental services such as typing notes, drawing checks, and accompanying her husband to luncheons and dinners do not establish her presence as necessary to the conduct of her husband's business. It also points out that if, on the business trip, the taxpayer engages in local sightseeing, entertaining, and visiting unrelated to his business, the pertinent expenses are personal and nondeductible. As a guide in determining the *amount* deductible, the ruling points out that such amount is that which is "directly related to the business purpose of the trip, that is, the cost at the single rate for similar accommodation[42]."

The "Double Tax"

Despite these rules, and the plethora of court cases sustaining the Commissioner, the abuse of the deduction for business expenses continued to flourish. During 1956, in an unpublished memorandum, there arose the first foreshadowing of the Service's taking more drastic measures in the field, through the taxation of disallowed corporate expenses as dividends to officer-stockholders. However, except in the most flagrant cases, the suggestion was not adopted at the field examination level. A further and much stronger interdepartmental order was issued in May of 1957, and from that date forward a new problem was added to the horror of the confusion — that of the "double tax."

The policy of double taxation has never been officially announced, although early in 1957 the Commissioner strongly intimated that steps were going to be taken to correct the use of business deductions such as travel, entertainment, club dues, yachts, automobiles, and company-supported resi-

39. Rev. Rul. 54-497, 1954-2 CB 75.

40. Rev. Rul. 55-57, 1955-1 CB 315.

41. Rev. Rul. 56-168, 1956-1 CB 93.

42. See Jack Schlosser, "Travel and Entertainment Expense," NYCPA, December 1956, p. 719. But *cf Faitoute Iron & Steel Co.* (1928), 11 BTA 818 where the Court allowed to a corporation the expenses of both a taxpayer and his wife on a business trip to South America, but then treated the reimbursed expenses of the wife as income to the husband and allowed him no deduction therefor. It is indicative of the change in the Commissioner's attitude to note that he acquiesced in this decision (VII-2 CB 12) which would not be so today. See Ernest J. Sargeant, "Matrimony and the Family Business," 15 N.Y.U. Institute on Federal Taxation, pp. 804-808. See Regs. Sec. 1.162-2(b)(2).

dences, as fringe benefits to officer-stockholders and other employees[43]. The courts generally have upheld the position of the Commissioner that advances by a corporation to an employee which were labeled "business expenses" but from which, in fact, the employee derived personal benefits, were not only to be disallowed to the corporation, but were to be taxed to the individual as "dividends[44]."

Nevertheless, this procedure is not foolproof since it can defeat itself by leaving the corporation with no earnings and profits available for dividends. The disallowances resulting in deficiencies in income tax reduce the earnings and profits available for dividends in the year of the deficiency[45]. Further, the earnings and profits available for dividends are also reduced by the interest on the deficiencies annually accrued for the taxable years involved[46]. If there were no earnings and profits available for dividends, there is some question as to whether the Courts would uphold a double taxation based upon merely the contention that the amount of personal benefit was "other income." Certainly, if the amount was treated as additional compensation, it would constitute a deduction to the corporation, thus eliminating one of the two taxes[47].

There also arises a very interesting technical problem: How does the basis of the agent's disallowance of the expense to the corporation affect its taxability to the individual? If the deduction is disallowed at the corporate level as being excessive and unreasonable, this in itself would not indicate that the recipient or recipients enjoyed any personal benefit therefrom. If the deduction were disallowed as being "unsubstantiated" there is some question as to whether this, in itself, would indicate that personal or non-business expenses were paid on behalf of or to the employee. If the disallowance was based upon the expense not being proximate to the carrying on of a trade or business, or not being an ordinary and necessary business expense, there is carried the implication of personal benefit to an individual.

Administrative problems raised are infinite, and are by no means limited to the gargantuan task of disproving personal benefit from the use of company cars, club memberships, attendance at sporting events, etc. For example, an individual whose return has been examined in "office audit" may be subject to a supplemental determination when his corporate employer's return is subsequently examined. An individual officer-stockholder in multiple corporations might be called on several times for review. An individual who reports on a calendar year basis, but who is employed by a fiscal year corporation, faces further problems.

The result of this double taxation policy of the Commissioner is, in many cases, a tax of more than 100 per cent of the amount disallowed. Since the corporation rate is 52 per cent, an officer-stockholder need only be in the 50 per cent bracket to be subject to a confiscatory tax. However, since it has

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43. I.R. Circular No. 57-85, June 20, 1957.

44. E.g., *Lucien I. Yeomans* (1945), 5 TC 870; *Regensburg* v. *Com.* (CA-2, 1944), 144 F(2d) 41, cert. den. 323 U.S. 783; *Louis Greenspon, et al.* (CA-8, 1956), 229 F(2d) 947.

45. *Stern Bros. & Co.* (1951), 16 TC 295.

46. *Sidney Stark* (1958), 29 TC ______ No. 17.

47. The Commissioner could contend, of course, that the salaries paid plus the amount taxed to the employee as "personal benefits received" constituted unreasonable and excessive salaries and was therefore not allowable as a deduction by the corporation.

long been accepted that ordinary dividends are taxed at more than 100 per cent, there appears to be no possible relief in claiming that this is a tax upon capital.

Various artificial expediencies have been tried to obviate the danger of the double tax, in some cases even to the detriment of normal business operations. Under the 1958 Act, the stockholders of certain "small business corporations" may elect not to be taxed as a corporation but to have their proportionate share of the corporation's income taxed to them individually. Thus, expenses disallowed would be taxed at only one level[48].

Another method which has been tried in the case of manufacturing corporations is the creation of a sales agency organized as a partnership. In such situations, all of the business expenses are paid through the agency. Thus, any disallowance to the partnership results only in a tax to the individual partners.

Another solution which has been attempted is to have all of the expenses borne by the employee, none of which are reimbursed, and to have the employee claim the deductions on his personal return. Where a corporate officer claims as a deduction travel or entertainment expenses which are not reimbursed to him by the corporation-employer, it is incumbent upon him to prove that such expenses are necessary to the earning of his remuneration, otherwise they are deductible by neither the officer nor the corporation[49]. The Commissioner's explanation is that "a corporation and its officer are different entities" and "the statute does not permit the deduction by one taxpayer of the expenses of a separate and distinct taxpayer." However, if the officer receives an allowance, or there is a corporate resolution requiring him to assume such expenses, the Commissioner states that this would "tend to indicate that these are a necessary expense of his office." The absence of this evidence is not necessarily fatal, but does increase the taxpayer's burden of proof[50].

Line (6a)

With the appearance of the 1957 individual federal income tax forms 1040, a new furor arose, which has been termed the "line 6(a) confusion[51]." Originally the Service announced that any employee who was reimbursed for business expenses advanced by him during the year 1957, must report the total amount of these expenditures on line 6(a) of the form. This requirement would result in a tremendous record-keeping and reporting burden for employees and employers, particularly penalizing those firms where strict and detailed records were kept and where even the smallest expenditures are reimbursed through petty cash vouchers.

On November 11, 1957, the Commissioner issued a statement[52] explaining that this was no real change in

48. Sec. 64, 1958 Technical Amendments Act. A small business corporation is defined as one having only one class of stock owned by not more than 10 individual stockholders, including estates, none of whom is a nonresident alien.

49. *Hal E. Roach* (1930), 20 BTA 919.

50. Rev. Rul. 57-502, *supra. Andrew Jergens, supra; Carl J. Schmidlapp* v. *Com.* (CA-2. 1938), 96 F(2d) 680; *Tyler*, 13 TC 186. See discussion of *Walter I. Geer*, 28 TC ___ No. 112. in NYCPA Nov. 1957, p. 791. But *cf Harder* TC Memo Op., 1958-97, where the Court allowed the taxpayer certain expenses in his capacity as a salesman which would not have been deductible by him as an officer.

51. See Thomas Graves, "Reimbursed Expenses," *Journal of Accountancy*, June 1958, p. 27.

52. News Release IR 204, Nov. 11, 1957.

policy, but that the new form was devised merely to provide space for taxpayers to claim deductions, and to enable them to develop information which would aid in more effective correction of the abuses. Nonetheless, by the end of November the Commissioner found it necessary to abandon his position and issue a statement[53] that in view of the fact that most taxpayers would be faced with an insurmountable burden because the policy was not announced in time for taxpayers to keep necessary records, the use of line 6(a) would not be required for 1957 returns.

Early in 1958, the Commissioner issued certain "proposed regulations" in an effort to set forth rules which would solve the questions raised by the "line 6(a) confusion." These proposed regulations with certain changes were adopted in final form in August 1958[54], accompanied by a news release setting forth the reasons and attitude of the Commissioner in their adoption[55].

The New Regulations

As an introduction to the new regulations, the Commissioner has stated that his purpose in promulgating them is to provide rules for reporting of ordinary and necessary business expense by taxpayers on their income tax returns, and for guidance as to the type of records which will be useful for compilation and substantiation. He further explains that the requirements do not apply to expenditures for incidentals such as fares, office supplies and the like. Such reimbursed expenses do not require reporting or substantiation by the individual[56].

Reporting Requirements

Reporting of amounts received and disbursed is not required where the amounts reimbursed are equal to the amounts expended (or where an employee does not claim any deduction for any excess of expenditures over reimbursements) provided that the employee has submitted a written expense account to his employer with respect to all expenses so incurred. In such a case, the employee is required only to submit a statement with his return that his reimbursements did not exceed the amounts expended[57]. Presumably this would place the burden of substantiation on the employer.

The second instance in which a statement need not be submitted is where the employee has received reimbursements in excess of the amounts expended (again, where the employee accounts to his employer). In this situation, the *excess* must be included in income and the taxpayer must make a statement to this effect on his return[58].

The two cases in which reporting in the form of a statement is required are: (1) where the employee has incurred expenses in excess of the amount reimbursed and claims such excess as a deduction[59]; and (2) in all cases where

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53. News Release IR 206, Nov. 25, 1957.

54. TD 6306 covering Regs. 1.162-17.

55. IR-235, August 27, 1958.

56. Sec. 1.167-17(a).

57. Sec. 1.162-17(b)(1). There is no Line 6(a) on the 1958 returns. There are two questions to be answered: "Did you receive an expense allowance or reimbursement, or charge expenses to your employer?" and "If 'Yes,' did you submit an itemized accounting of expenses to your employer?"

58. Sec. 1.162-17(b)(2).

59. Sec. 1.162-17(b)(3).

the employee is not required to "account" to his employer[60].

The Commissioner explains the meaning of "account to his employer" by providing that this "means to submit an expense account or other written statement to the employer showing the *business nature* and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses and other business expenses."[61] Thus, the employer, upon receipt of the expense voucher will have to distinguish and reimburse the employee only for those expenses which were not charged directly to the employer.

In either of the cases where the expenses must be reported, the employee must submit a statement with his return indicating the amount received from his employer, including therein any amounts charged directly or indirectly to his employer, and the details of his expenses broken down into the broad categories described above. In addition, the statement must also contain the nature of the employee's occupation and the number of days spent away from home overnight in connection with his employment[62].

Substantiation

The new regulations indicate that upon examination of their returns, employees will be required to substantiate their expenses in several types of situations. Substantiation will be required in all cases where reporting is required[63]. In addition, substantiation will be called for where the taxpayer has a relationship with his employer because of which, under the Code, he would be denied deductions of any losses incurred[64]. This includes employees who directly or indirectly own more than 50 per cent of the stock of the employer (if a corporation)[65], or in the case of a non-corporate employer, those who are a member of the employer's family, including brothers and sisters, stepbrothers and stepsisters, spouse, parents and grandparents, and children and grandchildren[66].

Another case in which substantiation will be required, whether or not a statement is required, is where the *employer's* accounting for, and substantiation of, employees' expenses is deemed inadequate[67]. Obviously, this is the situation which results in double tax on expenses disallowed to the employer, since if substantiation is inadequate on the employer's level, it is doubtful if the employee will have better proof.

The regulations require that adequate and detailed records be kept of such expenses as travel, transportation, entertainment and similar business expenses. In these records, the taxpayer should indicate why such expenses were necessary to the earning of *his* income. As has been discussed before, since the

60. Sec. 1.162-17(c).
61. Sec. 1.162-17(b)(4) (emphasis supplied).
62. Sec. 1.162-17(b)(3) and (c).
63. Sec. 1.162-17(d)(1)(i) and (ii).
64. Sec. 1.162-17(d)(1)(iii).
65. Sec. 267(b)(2) IRC 1954.
66. Sec. 267(c)(4) IRC 1954.
67. Sec. 1.162-17(d)(iv).

corporation and the individual are separate and distinct entities, unreimbursed expenses on behalf of the corporation, which are not ordinary and necessary to the individual, are deductible by neither[68].

One method suggested by the Commissioner is maintaining a daily diary plus the retention of supporting documents, especially in connection with large or unusual expenditures. Recognizing the difficulty of maintaining detailed records or of obtaining and preserving documents supporting all expenses, the Commissioner has stated that detailed records of small expenditures incurred in travel or transportation (such as tips) will not be required, but may be established by approximations based upon secondary sources of information and collateral evidence[69]. For example, when the taxpayer's position and occupation are taken into account, and he can show the class of hotel and type of accommodations, the size and number of tips may be reasonably estimated.

Immediately following the promulgation of the new regulations in final form, the Commissioner supplemented them with a promised ruling.[70] This ruling sets forth circumstances under which an employee's allowances (for which he does not account to his employer) shall be deemed to be equivalent to an accounting. Under these circumstances, the employee need not submit a detailed report. Thus, if an employee receives a mileage allowance of not more than $12\frac{1}{2}$ cents per mile, or a per diem allowance in lieu of subsistence of $15 or less[71], he shall be deemed to have accounted to his employer. The ruling also provides that if circumstances require a larger allowance, a request for a ruling can be submitted[72]. The granting of such a ruling shall establish rates under which the taxpayer shall be deemed to have made an accounting, and thus need not report.

Problems Raised by the Regulations

Unfortunately the Regulations raise new practical problems. If, for example, a taxpayer's employment contract, whether written or oral, provides for reimbursement upon an accounting of all expenses incurred in pursuance of his duties, but does not provide reimbursement for expenses incurred by that employee in trying to obtain new customers on his own time, the employee apparently would have to submit a statement of *all* expenses and reimbursements in order to obtain a deduction for the latter type of expenditures for which he was not reimbursed[73]. Another example very near home is that of the staff accountant who is reimbursed for all expenses, but wishes to deduct membership dues in The New York State Society of Certified Public Accountants and in the AICPA, and subscriptions to professional journals.

Is there really a distinction between

68. See discussion in 4 *Mertens* Sec. 25.12, footnote 31.

69. Sec. 1.162-17(d)(2) and (3). The diary should contain at least the following information: date, amount expended, persons entertained, place of entertainment, type of entertainment (e.g., lunch, dinner, bar, theater, etc.), business purpose (e.g., prospective customer, buyer, salesman, etc.) and, if reimbursed, the date of receipt.

70. Rev. Rul. 58-453, 1958-37 IRB, first appeared as T.I.R. No. 91, Sept. 8, 1958.

71. These amounts are 125 per cent of Government allowances.

72. Requests for such rulings should be sent to: Commissioner of Internal Revenue; Attention: Tax Rulings Division, Washington 25, D. C.

73. It has been argued that since the obtaining of new customers might result in promotion and increased income to the employee, such deductions would fall under Sec. 212 and thus no statement under Sec. 162 would be required.

the two examples insofar as the requirements for reporting are concerned? Certainly the professional expenditures of the accountant are not "reimbursed" expenses. Are they business expenses? Since they are covered in the regulations under Section 162 (which is entitled "Trade or Business Expenses"), they are considered so by the Commissioner[74]. Do we then attempt to distinguish on the basis that they are not "reimbursed"? This would be true of the first example as well as other types of situations at which the regulations were aimed. It must be obvious that any taxpayer who claims deductions for entertaining expenses will be called upon to provide the complete statement. It would appear, therefore, that in our examples we have a difference without a distinction. Certainly, semantics will not provide the answer. Yet we do not believe that the accountant's situation is one for which it was intended that a statement should be furnished.

Since it would appear, however, that a strict interpretation of the regulations would require complete statements in both of the foregoing cases, it would be necessary for the taxpayers to keep records of reimbursed expenses. But such records may not provide sufficient proof upon examination since substantiation of all reimbursed expenses will have been submitted to the employer. Since, under most bookkeeping systems, the employer does not segregate such vouchers by employee, assembling such vouchers for any individual employee becomes an onerous, if not impossible, task. It therefore behooves any employee who is reimbursed for the type of expenses for which a statement might be required under Section 1.162-17 of the regulations, to keep a diary of all expenses, reimbursed or otherwise, and, in addition, to keep duplicates of the vouchers submitted to the employer.

Another purely practical problem is that of the officer-stockholder who submits a statement showing both reimbursed and unreimbursed expenses. Even though all of the expenses claimed are bona fide, it is rare that more than a small proportion can be substantiated by actual vouchers. An application of the Cohan rule would probably result in allowance only of the amount reimbursed, and the chances of obtaining deductions for a substantial portion of the excess may be slight.

Conclusion

Throughout the voluminous cases of litigation involving disallowed business expense, it is apparent that the vast majority of cases turn on substantiation[75]. But a far greater percentage of cases involving disallowance because of lack of proof are decided at the field examination level. Thus, the best way to protect the deductions for business expense is to provide proof. When expenses are fully substantiated, it is rare that the question arises as to whether they are ordinary, necessary, reasonable, or incurred in connection with the business unless they are blatantly personal in nature. Obviously, the summer junket abroad, the winter vacation to Florida and the Christmas cruise of the officer-

74. Regs. 1.162-6 specifically cover professional expenses. Regs. 1.212 do not. It could be argued that such expenses are not "in connection with services as an employee" (Sec. 1.162-17(a)), or, as stated in the instructions to accompany form 1040, "in connection with his employment." The danger in such an argument is to infer that such expenses are for future personal gain and hence may be disallowed under Regs. Sec. 1.212(f).

75. Recently a new influx of decisions and rulings involve what constitutes "away from home" in connection with travel expense. The scope of this article does not permit of a discussion of this problem.

stockholder of a close corporation not only are objects of prime suspicion, but can cast doubt upon all other expenses claimed as business deductions. Deductions for company-owned cars, company-owned yachts, company-owned vacation resorts are red flags and should only be claimed where the strongest evidence of their business use and necessity is available.

It cannot be gainsaid that every case must stand on its own. It must also be realized that every field examination depends on the examining agent. There have been cases within our knowledge where the examining officer has refused to accept as substantiation a minutely detailed diary on the grounds that it was too perfect. Certainly, it is evident that membership in a credit card club supplying monthly statements is not enough, in and of itself. Every dining charge must be related to its business purpose through identification of the guests and their proximate relationship to the taxpayer's earning of income.

Further, expenses should bear some relationship to the business benefit expected. It is difficult to convince the Internal Revenue Service that the substantial expenses incurred for a two-week stay in Florida are ordinary, necessary and reasonable for a visit to a customer who makes occasional purchases in small quantities of the taxpayer's product, and who has no potential for a substantial increase. Business expense deductions are not intended to constitute tax-exempt fringe benefits and the Internal Revenue Service will not allow them as such. They will be audited in the light of whether they would be incurred by a reasonably prudent business man *if there were no tax benefits involved*, and should be so considered by the taxpayer.

Insofar as the burden of keeping adequate substantiation is concerned, it is well to consider the effort and expense involved in earning sufficient income to equal the out-of-pocket loss resulting from the disallowance of unsubstantiated deductions. Records supporting deductions should be prepared with the same acumen and care that other phases of the business require—and probably with more care.

Recent Developments in Accounting for Employee Benefit Plans

By Isidore Platkin, CPA

In addition to outlining some of the more important recent developments affecting the accounting and auditing of employee benefit plans, the author of this article has also provided pertinent background material to aid in the recognition of trends which may have significant bearing upon the CPA's role in this field.

The last decade has seen a tremendous increase in the number of plans established for the benefit of employees, including welfare funds, pension plans and profit-sharing plans. Frequently the result of collective bargaining agreements, such plans also are often instituted through unilateral employer action, to provide employee incentives and to supplement governmental social security, unemployment insurance, and disability programs.

Employer contributions to these plans often involve a considerable cost and a question frequently asked is whether the same amount would not be better spent if paid out as direct salary and wage increases rather than for "fringe benefits." An obvious answer is that unless these wage increases were treated as savings by the employee, or used by him to purchase insurance of various types, the employee would not be protected against the very contingencies for which many of the plans provide; nor generally, could he obtain as much protection at the same cost.

Another, and perhaps more important reason for the popularity of many of these plans relates to their tax advantages. The tax on these benefits often is deferred, ultimately to be applied at capital gains rates only, while many of the benefits escape taxation entirely. Because of these tax advantages, independent practitioners such as lawyers and certified public accountants, after helping clients set up employee benefit plans have, on occasion, like Pygmalion, become so enamored of their creation that they have given up their practices and accepted employment with the former clients, in order to obtain these benefits themselves. For the same reason, partnerships and single proprietorships have been known to in-

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corporate so that the erstwhile owners could assume employee status and obtain coverage under employee benefit plans. An increasing number may be expected to do so, now that the Mills Bill has been passed, providing election by small business corporations to be taxed as partnerships.[1]

But the corporate route to employee benefits often is not feasible, and in the case of most professional partnerships is not even permissible. It therefore may be of interest to the reader to hear the last word in the *Kintner* case, the famous attempt by a professional partnership to overcome these obstacles.

Kintner-Type Associations

The significance of the recent modification by the Internal Revenue Service of its position on Kintner-type associations can be understood only in the light of a knowledge of the facts involved in the *Kintner* case. The story goes back to 1948. In that year, a medical partnership, of which the taxpayer Doctor Arthur R. Kintner, was a member, was dissolved. In its place the former partners organized an association which they intended to be taxed as a corporation, and set up a pension plan for the benefit of the association's employees. As doctors, the former partners could not, under state law, operate as a corporation. As a partnership, a pension plan which would benefit the partners could not qualify under federal law. The association which was created to succeed the partnership appeared to be the answer to the dilemma.

Upon examination of Dr. Kintner's return for 1948, the government held that the association should be treated as a partnership and not as a corporation, that amounts contributed to the pension fund on his behalf were therefore taxable to him, and asserted a deficiency. The doctor paid the assessment, filed a refund claim, brought suit thereon, and in 1952 obtained a favorable decision from the District Court.[2] The government appealed, but again the doctor was sustained, this time by the Court of Appeals for the Ninth Circuit, in a 1954 decision.[3]

In 1956 the Internal Revenue Service issued a ruling [4] to the effect "that a group of doctors who adopted the form of an association in order to obtain the benefits of corporate status for purposes of Section 401(a) [5] of the Internal Revenue Code of 1954 is in substance a partnership for all purposes of the Internal Revenue Code." In a later ruling [6] containing a compilation of rules dealing with qualification of Section 401 (a) plans, the Service specifically excluded from eligibility a group of doctors adopting the form of an association.

Against this background of persistent opposition to the *Kintner* decision, the Service recently announced that it had modified its position and that whether an unincorporated association of professional persons would be taxable as a partnership or a corporation would depend on the usual tests, not on whether it had established a pension plan under Section 401 (a), and that a revenue ruling to be published later would contain basic criteria to be used in making such tests.[7] To date, the proposed ruling has not been published.

This modification of its position by the Service is of particular interest at this time because of the failure of passage of the Jenkins-Keogh bill [8] in the last Congress. This bill, a modified version of similar bills introduced in previous sessions, would have permitted limited tax deduction for retirement plans established by the self-employed. The bill was passed by the House but was not reported out by the Senate Finance Committee.

State Supervision and Regulation of Benefit Plans

With the growth in the number of plans in existence, the value of their assets, and the number of persons affected, it was inevitable that regulatory legislation would be enacted. Washington, in 1955, became the first state to pass such legislation. The six states which now have such statutes on their books, and the administering departments are:

State	Administering Department
California	Insurance
Connecticut	Insurance
Massachusetts	Board composed of Commissioners of Labor and Industry, Banks, and Insurance
New York	Banking—if corporate trustees Insurance—all other
Washington	Insurance
Wisconsin	Insurance

The trend indicates that additional states will pass such laws in the near future and that existing laws in the six states listed will be broadened to include employee benefit plans and funds not now covered.

Recent New York State Legislation

During its last session the New York State Legislature passed two significant pieces of legislation affecting welfare funds. One makes it a misdemeanor for an employer engaged on a public works contract for the state, to fail to make required contributions to a negotiated plan.[9] To the extent that this will reduce contribution arrears it will be a material aid in one of the problem areas of auditing and accounting for welfare funds, namely, the evaluation of unpaid contributions. The other noteworthy item of legislation gives to the superintendents of insurance and of banking the power to prohibit the trustees of a fund from employing any person where a conflict of interest is involved. Such action by the respective superintendents would be taken after notice and a hearing, and would be subject to judicial review.[10]

When first introduced, the Senate version of the latter bill dealt with prohibition of employment of any person acting in a "dual capacity." The Society's Committee on Employee Welfare Plans and Funds was concerned with the possibility that this might be construed to mean that an independent accountant could not simultaneously be retained by a fund and by a contributing employer or a participating labor organization. The New York State Society of Certified Public Accountants addressed communications to the two superintendents expressing its concern. The bill as finally passed is in the form in which it was introduced in the Assembly and deals with "conflict of interest" which appears to be less objectionable than "dual capacity." Furthermore, assurances have been received from officials to the effect that the bill was not intended to apply in the ordinary situation where an accountant, acting independently, performs services simultaneously for a fund and a contributing employer or participating labor organization.

Uniform Statement Forms—Activities of Insurance Department Officials

A subcommittee of the Blanks Committee of the National Association of Insurance Commissioners has been appointed to consider uniform statement blanks to be used in all states which have passed welfare and pension fund legislation. Its membership includes representatives from the insurance departments of the six states which have passed such legislation.

A meeting of this subcommittee was held on March 27 and 28, 1958 at the

offices of the New York State Insurance Department. The first day of the meeting was devoted to an open hearing at which two sets of forms were discussed —those used in Wisconsin and a modified version of the New York State forms. The attendance included representatives of welfare funds, the insurance and banking industries, welfare fund consultants, and several members of The New York Society of Certified Public Accountants' Committee on Employee Welfare Plans and Funds. The latter committee had previously submitted its views in writing and again expressed them orally at the meeting. The second day of the meeting was devoted to an executive session. After considering the various proposals and suggestions which had been submitted, the subcommittee adopted a set of forms which was to be further considered at a meeting in Chicago on June 7. Suggestions again were submitted by The New York State Society of Certified Public Accountants as well as by the American Institute of Certified Public Accountants and other interested organizations.

The subcommittee voted to defer final adoption of uniform blanks until the next meeting of the N.A.I.C. in December, and to hold another meeting of its own on October 2 and 3 for further consideration of the various proposals it had received. As the matter now stands, therefore, the forms originally adopted at the March 27-28 meeting have no official status and may possibly be discarded or considerably revised before any final action is taken. A brief description of these forms, nevertheless, may be of interest as an indication of what may possibly be expected in the future.

Perhaps the best description would be a comparison with the forms now used by the New York State Insurance Department, after which they largely are patterned. In general, it may be stated that the proposed forms were considerably simplified and condensed. The major differences are as follows, all specific reference being to the present New York forms:

1. *Size.* Reduced from an unwieldy 11" x 11" to a much more practical 8½" x 11" page.

2. *Exhibit 2 (Profits and Losses on Disposal of Investments).* Reduced from 5 columns to 3 columns. Eliminates the need to report for each security listed: from whom purchased and date; to whom sold and date; and actual cost.

3. *Exhibit 3 (A Detailed Listing of Increases and Decreases of Asset Values).* Dispenses with this exhibit completely.

4. *Exhibit 6 (Analysis of General Expenses).* The present New York State forms call for reporting expense categories on a cash basis, adding accruals at the end of the year, and deducting accruals at the beginning of the year, the object being to arrive at total expense on an accrual basis. The tentatively adopted forms permit reporting directly on an accrual basis if the accounts are so kept.

5. *Schedule C (Bonds Owned).* Reduced from 6 to 3 columns. Name of vendor, date acquired, actual cost, and interest received during the year are not required.

6. *Schedule D (Stocks Owned).* Reduced from 7 columns to 4 columns. Name of vendor, date acquired, actual cost, and dividends received during the year are not required.

7. *Schedule E (Cash in Banks).* Listing of totals of bank balances at end of each month not required. But year-end balances are to be grouped as to "on

interest" or "not on interest" and the total of each category is to be shown separately in the Statement of Assets.

Accountants will be interested in the fact that of the forms considered by the subcommittee, the Wisconsin forms permit use of the cash or accrual basis of reporting whereas the New York forms and those tentatively adopted favor the accrual basis. In the case of employer and employee contributions, however, the tentatively adopted forms permit reporting on either a cash or accrual basis.

An interesting item on the instructions to the tentatively adopted forms, and one which may well prove to be a controversial one, is the requirement that investments in shares of savings and loan associations and credit unions shall be listed among stocks owned.

Uniform Statement Forms—Activities of Banking Department Officials

The National Association of Supervisors of State Banks likewise has established a subcommittee on uniform blanks to work with the corresponding N.A.I.C. committee. The banking officials' group has not yet attempted to develop any forms of its own but is giving careful consideration to those drafted by the N.A.I.C. group and has tentatively adopted a number of comments and suggestions for changes. It is hoped that the work of both committees will be coordinated, that the final forms will be acceptable both to insurance and banking departments, and that all states which have enacted regulatory legislation dealing with welfare funds will use substantially the same forms.

Recent Federal Legislation

Culminating efforts extending over several years, the Congress has finally passed a "Welfare and Pension Plans Disclosure Act" at its last session. It was signed by the President on August 28, 1958 and becomes effective January 1, 1959.

The bill has had a checkered career indicating that amendments may be expected in the near future. Introduced in the Senate by Senator Douglas it was passed by that body by a vote of 88-0. The House in turn passed a bill introduced by Representative Teller, which differed considerably from the Senate version. The compromise measure adopted was based generally on the House bill.

Upon signing the act as finally passed,[11] the President criticized it severely. He explained his action in approving it by stating that it "establishes a precedent of Federal responsibility in this area" but added that "it does little else." He further declared that "if the bill is to be at all effective, it will require extensive amendments at the next session of Congress." The President's criticisms were based on the following grounds which he cited as "some of the bill's shortcomings":

1. It fails to provide necessary protection for the 85 million working men and women whose interest in welfare and pension plans amounts to more than $30 billion.

2. It requires only summary statements on many important aspects of the financial operations of these plans, making it possible to conceal many abuses.

3. There is no agency of Government authorized to provide uniform interpretation of the bill's technical terms. The chaos that will result is obvious.

4. It fails to designate an agency which plan administrators can consult for reliable and authentic opinions, and for meaningful and uniform report forms.

5. The bill relies solely upon individual employees to compel compliance through court proceedings.

6. The bill fails to give the Secretary of Labor either investigatory or enforcement powers with respect to reports filed with him.

7. There is no provision for dealing directly with the most flagrant abuses, such as embezzlement and kickbacks, once they are uncovered.

8. The Congress failed to appropriate any monies to administer the custodial and other functions of the Secretary under the bill.

9. The annual financial reports will not have to be furnished until as late as May, 1960, if the plans are on a calendar basis or for a period of 120 days after the completion of the fiscal year if they operate on a fiscal year basis.

The new law applies to employee welfare benefit plans and employee pension benefit plans which are communicated to or their benefits described in writing to the employees. An "employee welfare benefit plan" is defined as one "established by an employer or by an employee organization, or by both, for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, medical, surgical, or hospital care, or benefits in the event of sickness, accident, disability, death, or unemployment." An "employee pension benefit plan" is defined as one "established by an employer or by an employee organization, or by both, for the purpose of providing for its participants, by the purchase of insurance or annuity contracts or otherwise, retirement benefits, and includes any profit-sharing plan which provides benefits at or after retirement." Of course the Act contains the usual "commerce" clause so as to apply coverage to those engaged in interstate or foreign commerce or in an activity affecting "commerce."

Four types of plans are excluded from coverage under the Act.

1. Those administered by the Federal government, by a State or political subdivision thereof, or by any agency or instrumentality of the foregoing.

2. Those established solely to comply with workmen's compensation laws or unemployment compensation disability insurance laws.

3. Those established by certain tax-exempt organizations.

4. Those which cover not more than twenty-five employees.

Within ninety days of the effective date of the Act (i.e., by April 1, 1959) or within ninety days of the establishment of the plan, whichever is later, the administrator shall publish a description of the plan. Within one hundred and twenty days after the end of the calendar or fiscal year of the plan, the administrator shall publish an annual report. The information contained in the report "shall be sworn to by the administrator, or certified to by an independent certified or licensed public accountant, based upon a comprehensive audit conducted in accordance with accepted standards of auditing."

Publication of the plan's description and annual report shall be made to participants and their beneficiaries by any of the following methods:

1. By making copies available for examination at the principal office of the plan.

2. Upon written request, by mailing a copy of the description of the plan and a summary of the latest annual report.

3. By filing with the Secretary of Labor two copies of the description of the plan and of each annual report, which shall be available for public examination.

Forms for descriptions of plans and annual reports are to be prepared by the Secretary of Labor.

Reporting Requirements Under the Federal Disclosure Act

The new law outlines the information to be included in annual reports and specifies what is to be contained in reports on welfare benefit plans and on pension benefit plans, depending on whether funded through the medium of a trust or through a contract with an insurance carrier. Among the data to be included are the following:

1. The amount contributed by the employer or employers.

2. The amount contributed by employees.

3. The amount of benefits paid or otherwise furnished.

4. The number of employees covered.

5. A summary statement of assets, liabilities, receipts and disbursements. The assets are to be broken down by types, such as investments in governmental obligations, investments in nongovernmental bonds, and investments in corporate stocks.

6. A detailed statement of salaries and fees and commissions charged to the plan, showing to whom paid, the amount, and for what purpose.

7. If any of the benefits are insured, the premium rate or subscription charge, the total premiums or subscription charges paid to each insurer, the approximate number of employees covered by each class of benefits, and the total claims paid.

8. Additional information in connection with insurance charges, including dividends or retroactive rate adjustments, commissions and fees paid by each carrier, the names and addresses of brokers, agents and others to whom commissions or fees were paid, the amounts and purposes.

9. A detailed list containing specific information with respect to investments in securities of an employer or employee organization or of any other party in interest, such as an officer, trustee, or employee of the fund. However, the identity of securities, and commissions on purchase or sale need not be revealed under certain conditions if the securities are traded on exchanges subject to regulation by the S. E. C., or are registered under the Investment Company Act of 1940 or the Public Utility Holding Company Act of 1935.

10. A detailed list of all loans made to an employer, employee organization or any other party in interest.

11. In the case of an employee pension benefit plan funded through the medium of a trust, the type and basis of funding, actuarial assumptions used, the amount of current and past service liabilities, and the number of employees, retired and non-retired, covered by the plan.

12. In the case of an employee pension benefit plan funded through the medium of an insurance contract, the type and basis of funding, actuarial assumptions used in determining payments under the contract, the number of employees, retired and non-retired, covered by the contract and to the extent benefits are not completely guaranteed by the carrier, the amount of current and past service liabilities based on those assumptions and the amount of all accumulated reserves.

13. If the plan is not funded, the total benefits paid, the average number

of employees eligible for participation for each of the past five years, and a statement, if applicable, that the only assets from which claims may be paid are the general assets of the employer.

Extension of Time for Disposal of Employer Debentures

Section 503 of the Internal Revenue Code of 1954 denies exemption to an otherwise qualified employees' trust which lends money to the employer without the receipt of adequate security. This prohibition would apply to employer debentures purchased on or after March 1, 1954. In view of pending legislation to amend this section, the Internal Revenue Service allowed a grace period for disposition without penalty if such debentures were purchased before November 9, 1956. This period was extended several times by revenue rulings and technical information releases pending issue of applicable regulations. The regulations [12] as issued now provide for termination of such grace period by March 15, 1959, or the ninetieth day after enactment of amending legislation, whichever is earlier.

The legislation in question has now been passed as Section 30 of the Technical Amendments Act of 1958 (Mills Bill). It adds another subsection to Code Section 503, providing in effect that purchase by a trust of an employer's unsecured obligations shall not constitute a prohibited transaction if the obligation is acquired on terms not less favorable than those available to the public; if the trust owns not more than 25 per cent of any one issue; and if not more than 25 per cent of the trust's assets are invested in obligations of the employer. The new provision is given retroactive effect and applies to taxable years ending after March 15, 1956. If debentures do not qualify for retention under the new rules, the grace period for their disposal will terminate on December 1, 1958, which is ninety days after September 2, 1958 when the Act was signed by the President.

Present Status of Bankrupt Employer's Unpaid Contributions

A recurring problem in accounting for employee benefit funds is the valuation of contributions due by a bankrupt employer. If such contributions are deemed unpaid wages they are entitled to a high priority and enjoy a preference even over unpaid taxes.

A 1957 decision [13] by the Court of Appeals for the Second Circuit held that unpaid contributions owed to a negotiated fund by a bankrupt employer were not "wages." A recent decision of the Third Circuit Court [14] took the contrary position and held that ". . . the contributions are in a true sense the agreed compensation for services rendered and as such must be considered wages." In view of the conflict between the two circuits, the ultimate decision must come from the Supreme Court, or, as suggested in the Second Circuit Court's decision, through legislative action.

A bill to this effect was introduced in the House of Representatives last year by Congressman Celler of New York.[15] It would have amended Section 64 (a) 2 of the Bankruptcy Act by adding the following: "and, further, for the purpose of establishing priority under this clause and for computation of the maximum claim to which priority can be given, payments due to any fund or plan established for the purpose of providing employee benefits, which are based upon hours worked or wages paid, shall, if such payments would qualify as deductible from the employer's gross income under the provisions of the Internal Revenue Code, be deemed to be wages assigned to the fund or plan by

the individual employees upon whose service or wages such payments are based." No action was taken on this measure in the last Congress but similar legislation may be expected to be introduced again.

Recent Internal Revenue Rulings and Announcements

Most of the published rulings issued by the Internal Revenue Service in connection with welfare, pension and profit-sharing plans, deal with the taxability of benefits. The following rulings, directly affecting such plans, may be of interest to the accounting practitioner.

Section (1) of Rev. Rul. 57-163 requires that where a qualified plan provides for stated or ascertainable amounts to be credited to participants, as in the case of profit-sharing plans and stock bonus plans and certain self-administered trusteed money purchase pension plans, it must provide for a valuation of securities at least once a year, on a specified inventory date. The valuation is to be based on the fair market value on the inventory date, in accordance with a method consistently followed and uniformly applied.

Rev. Rul. 58-143 provides, in essence, that where a labor union has an established plan for the payment of benefits to its members, a separate trust should be established for that purpose. Failure to do so, if required under the criteria and tests contained in this ruling, will affect the union's tax exemption under Section 501 (c) (5) of the Internal Revenue Code.

Rev. Rul. 58-442 clarifies the tax status of S.U.B. plans. It provides that a supplemental unemployment benefit plan, established as a result of a collective bargaining agreement, will be considered a voluntary employees' beneficiary association and will be entitled to income tax exemption under Section 501 (c) (9) of the Code if it meets all requirements of the section. The ruling points out that an organization may not consider itself exempt merely because it falls within the scope of the ruling, but must make application for exemption on Form 1026.

The Internal Revenue Service recently announced [16] that, in view of adverse court decisions, it no longer will litigate cases under the Internal Revenue Code of 1939 involving the taxability of voluntary payments to widows by the employers of their deceased husbands. Taxpayers who have been taxed on such payments should consider the advisability of filing refund claims. Here is one instance where the existence of a formal plan could have been detrimental tax-wise, since payment pursuant to a plan or other binding obligation would not be considered voluntary.

Growth in Literature and Organizational Activities

The increase in the number of plans in existence and in the laws and regulations affecting them has been paralleled by a growth in the literature dealing with their accounting and auditing problems, and in the activities of interested organizations.

Several excellent articles by certified public accountants have appeared in recent issues of the professional periodicals:

Hester Ellen Erb, "The Accounting Challenge in Employee Welfare Funds," JOURNAL OF ACCOUNTANCY, August 1955.

Percy A. Lockitch, "Audit and Tax Problems of Health and Welfare Funds," JOURNAL OF ACCOUNTANCY, January 1958.

Raymond Buchbinder, "Union Welfare Funds," THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, February 1958.

In this category should be mentioned the testimony on June 6, 1957 by Carman G. Blough, director of research of

the American Institute of Certified Public Accountants, before the Subcommittee on Welfare and Pension Funds Legislation of the Senate Committee on Labor and Public Welfare, during hearings on the then pending disclosure bills. In a prepared statement, and in answer to questions by members of the subcommittee, Mr. Blough outlined the functions of the auditor of an employee benefit plan, the audit limitations, and some of the audit problems. He also discussed the independent approach of the professional auditor, which prevents a conflict of interest when the same auditor examines the records of an employer and those of a benefit plan established by the employer.[17]

Another publication of interest is the "Code of Ethical Practices With Respect to the Insuring of the Benefits of Union or Union-Management Welfare and Pension Funds" adopted in December 1957 by the National Association of Insurance Commissioners.[18] The Code consists of eight sections devoted to the following matters:

1. Payment of benefits.
2. Commissions, fees and other allowances.
3. Relationship between the trustees (of a plan) and the insurer.
4. Improper inducements (in the acquisition of new business and efforts to keep business in force).
5. Cost presentations.
6. Equal treatment of policyholders.
7. Benefit descriptions.
8. Accounting. This section provides that the insurer should, at the end of each policy year, furnish an accounting statement to the policyholder which should include at least the following items, shown separately:

(a) Premiums received.

(b) Benefit payments.

(c) Commissions, fees and other allowances paid.

(d) Dividends, experience-rating refunds, or contractual returns of premium paid to the plan.

(e) Resulting balance.

This section on accounting provides that insurers should encourage the trustees of each welfare and pension fund also to render a summary report of the operations of the fund, not less frequently than annually, to persons having a bona fide interest in the plan, and should, to the fullest extent practicable, cooperate with the trustees in the preparation of such a report.

On May 4, 1955, the Executive Council of the American Federation of Labor adopted a set of "Guides for Administration of Health and Welfare Funds." More recently, on January 31, 1957, the AFL-CIO Executive Council approved Code II on "Health and Welfare Funds" of a six-part Code on Ethical Practices developed by its Ethical Practices Committee.[19] Both these items have received sufficient attention not to require any further comment at this point, except a suggestion that accountants working in this area should have copies thereof in their files.

The professional accounting organizations also have taken steps in the direction of helping practitioners to cope with the ever-mounting problems relating to these funds. The New York State Society of Certified Public Accountants recently created a Committee on Employee Welfare Plans and Funds and the American Institute of Certified Public Accountants has created a Committee on Labor Union and Welfare Funds.

Conclusion

In a paper dealing with recent developments in accounting for employee

benefit plans, it might be pertinent to state that perhaps the most striking development is the important place in our economy which is rapidly being assumed by such plans. As they have grown in importance, accounting and auditing problems and questions in this area also have developed. For example, should medical and recreational centers be capitalized or expensed? How should investments be valued? What is the responsibility of the auditor when benefits are payable to numerous individuals over a wide geographical area, many of whom may have died or have moved without reporting new addresses, since they became eligible for benefits? What is his responsibility in connection with part-time or itinerant employees for whom contributions may be due from a number of employers, or whose eligibility may be constantly changing? What is the most appropriate title for the equity section of an employee benefit plan—capital, surplus, unassigned funds? Indeed, what is the equity, the excess of assets over liabilities, or over liabilities and reserves? When should reserves be listed as liabilities, and when in the equity section? With a great many plans reporting on a cash basis, may such basis be considered in accordance with generally accepted accounting principles? How much detail should be included in reports submitted to beneficiaries? Too little may deprive them of information which should be made available to them; too much may prevent them from seeing the forest for the trees.

Better accounting and auditing procedures will be reflected in better administration of such plans, making possible greater efficiency and more benefits per dollar of cost. In the solution of problems such as these, and of many other existing ones not mentioned and new ones which are bound to arise, the accountant will find a fertile field for service to the community and to the profession.

References

1. Section 64, Technical Amendments Act of 1958.

2. *Kintner* v. *U. S.*, 107 F. Supp. 976, 42 AFTR 810.

3. *U. S.* v. *Kintner*, 216 F. (2d) 418, 46 AFTR 995.

4. Rev. Rul. 56-23.

5. This is the section dealing with qualification of pension, profit-sharing, and stock bonus plans for the exclusive benefit of employees or their beneficiaries.

6. Rev. Rul. 56-163.

7. Technical Information Release 61, reissued as Rev. Rul. 57-546.

8. H. R. 10.

9. Chapter 825, Laws of 1958, amending the penal law by adding a new section, 962-a.

10. Chapter 857, Laws of 1958, amending the banking law by adding a new section 71-2(c) and the insurance law by adding a new section 37-l. 2(c).

11. Public Law 85-836. (S. 2888).

12. Reg. Sec. 1.503(c)-1.

13. *Local 140 Security Fund* v. *W. S. Hack, Trustee in Bankruptcy of Sleep Products, Inc.*, 242 F (2d) 375, CA-2, 1957.

14. *Matter of Embassy Restaurant, Inc.*, 254 F (2d) 475, CA-3, 1958.

15. H. R. 8805.

16. Technical Information Release 87, August 25, 1958.

17. Reprinted in THE JOURNAL OF ACCOUNTANCY, August 1957, p. 69.

18. Copies may be obtained from the National Association of Insurance Commissioners, 160 N. La Salle St., Chicago 1, Ill., Suite 1732.

19. Published by American Federation of Labor and Congress of Industrial Organizations, 815 16th St. N. W., Washington 6, D. C. as Publication No. 50, reissued June, 1957; reprinted in THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT, August, 1957, p 553.

New York State Tax Forum

Guest Editor—OSCAR HANIGSBERG, CPA

Entire Net Income of Small Business Corporations

Particularly because of the "entire net income" base of the New York State franchise tax, new federal tax legislation always invites consideration of New York State consequences. The recently enacted sections dealing with the election of a qualifying small business corporation to have its income taxed to its shareholders (Internal Revenue Code Sections 1371 to 1377) raise a fundamental question. If, under these sections, the corporation has no taxable income, what happens to the "entire net income" base for the franchise tax? And, so far as the shareholders are concerned, can they be taxed with the so-called "undistributed taxable income."

That shareholders cannot be taxed with undistributed income of a corporation is clear because there is no provision for such taxation under the New York State income tax law. It appears that the franchise tax will likewise remain undisturbed despite the exercise of the federal election.

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Article 9A, dealing with the franchise tax of business corporations, states: "Sec. 208 *** 9. The term 'entire net income' means total net income from all sources, which shall be presumably the same as the entire net income which the taxpayer is required to *report* to the United States treasury department * * *." (Emphasis added.)

The franchise tax base is income required to be reported by the corporation—not income taxed to the corporation. The new federal law states: "Every electing small business corporation (as defined in Section 1371(a)(2)) shall make a return for each taxable year, stating specifically the items of the gross income and the deductions allowable by subtitle A . . . ." Since the electing corporation is required to report its net income even though it pays no tax thereon, the base for application of the franchise tax seems still to exist.

Distributions by Small Business Corporations

Another aspect of the electing small business corporation merits consideration. In computing a shareholder's share of undistributed taxable income, it is provided that the computation may not include any amounts arising from years prior to one in which the elec-

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ED. NOTE: For an interim period, until a permanent departmental editor has been selected, this department will be conducted by guest contributors.

tion is not in effect. The result is that where for one reason or another a corporation which had previously come under these sections ceases to be covered, a shareholder cannot freely withdraw earnings previously taxed but not distributed to him. He must wait until all current earnings and corporate surplus have been taxed to him as ordinary dividends before he can apply distributions to the adjusted basis of his stock. It has been suggested that the best way to avoid this undesirable situation is to distribute earnings currently since, in any event, the shareholder is being taxed with the income. If funds are needed by the corporation, they may be returned in the form of loans which can be repaid when funds are available. This may be a solution to a federal problem but one should not overlook the state income tax on the distribution. The income thus distributed and returned in the form of a loan would be subject to both the corporation's franchise tax and the shareholder's income tax.

Small Business Depreciation Allowance

Adding to the potpourri of factors that may now be taken into consideration in determining whether the corporate or individual (or partnership) form of doing business is more advantageous is the new federal extra 20 per cent first-year depreciation allowance. Because the franchise tax is based on federal net income, corporations will enjoy a benefit that is not available to individuals and partnerships without corresponding state legislation. The benefit is hardly of importance since it would be limited to $5\frac{1}{2}$ per cent of \$2,000, or \$110 in the first year, and that amount would be whittled away in succeeding years because of reduced depreciation charges.

Real Estate Corporations and Section 337

Section 337 of the Internal Revenue Code provides that if a corporation resolves to liquidate and does so within twelve months from the date of the resolution, gains and losses on the sale of its property within this twelve-month period are not recognized. Where a business corporation bases its franchise tax on net income, it benefits from the fact that a gain in a disposition covered by Section 337 is not included in taxable income.

If the corporation qualified as a real estate corporation taxable under Article 9 of the New York State Tax Law, its franchise tax would be based on its gross assets and no particular tax benefit would accrue to it despite the operation of Section 337. Furthermore, it would still be liable for an additional tax of 2 per cent on its net worth in excess of paid-in capital. Thus, a corporation subject to Article 9A would pay no franchise tax as a result of the sale and liquidation while a corporation subject to Article 9 would pay the additional 2 per cent tax.

The franchise tax on real estate corporations under Article 9 is generally less than the tax on business corporations under Article 9A, and classification as a real estate corporation is usually sought for. Where a relatively short life is projected for the corporation because of an intention to sell the property and a relatively large gain is anticipated on the sale, it may be worthwhile to pay the possibly greater business corporation tax for the limited period in order to avoid having to pay the additional 2 per cent tax under Article 9. This choice may be more practical than heretofore because of the liberalization of the federal rules governing collapsible corporations, since it is now possible to have an intention-

(Continued on page 834)

Accounting at the SEC

Conducted by Louis H. Rappaport, CPA

Discussion of Accounting Matters With the SEC Staff

There are many occasions when accounting matters must be discussed with the accounting staff of the SEC. For example, it is sometimes advisable to obtain the SEC's views on a particular accounting or auditing question before a registration statement or other document is filed with the Commission. Sometimes, after a registration statement has been filed, it may become necessary to confer with the accounting staff of the Commission as the result of a comment by the Commission in its "Memorandum of Comments" (more commonly known as the "deficiency letter") following its review of the registration document.

The company's independent public accountants should attend all such conferences having to do with accounting or auditing matters. There is no objection to having counsel also attend, but counsel should not undertake this task on his own. If he talks to the Commission about matters relating to the financial statements, he should always be accompanied by the company's independent public accountants and the controller or someone from his staff.

Louis H. Rappaport, CPA, *a partner in the firm of Lybrand, Ross Bros. & Montgomery, CPAs, is the author of* SEC Accounting Practice and Procedure.

When accounting questions are at issue, the Chief Accountant of the SEC has made it quite clear that he prefers to deal directly with controllers and representatives of the independent certifying accountants. If a lawyer attempts on his own to discuss accounting matters with the SEC staff, one of the first questions he will be asked is, "Where are the company's independent accountants and the controller?"

This is in no sense a reflection on lawyers. It is simply that the SEC wants to be sure that the accountants have been consulted and that they agree with the information and conclusions furnished by the lawyer.

Although accountants practicing before the Commission are required to be independent, there is no similar requirement with respect to lawyers. By the very nature of their calling, lawyers are advocates, and often they are asked by their clients to argue for their client's position on an accounting question. Even though the lawyer may be qualified to discuss a complicated accounting matter with the SEC, the staff is much more interested in obtaining the views of the accountant. The staff must know whether the accountant concurs in the statement of the client's views on the particular accounting matter at issue. This is only natural, since the financial statements embodying the accounting

matter in question usually must be certified by the independent accountants.

Some years ago this matter was discussed at a meeting of the National Conference of Lawyers and CPAs, a body consisting of five representatives of the American Bar Association and five representatives of the American Institute of CPAs. The Conference resolved that lawyers should recommend that accounting questions raised by the SEC be referred to the CPA concerned. This action was consistent with earlier statements of the Conference relating to tax practice, to the effect that CPAs should advise their clients to employ lawyers when legal questions arise; and lawyers should advise their clients to employ CPAs when accounting questions arise.

Official Releases

Voted Resolutions — Board of Regents
The University of the State of New York

Adopted June 27, 1958

Upon the report of the Regents Committee on Discipline, made in accordance with the provisions of chapter 514 of the Laws of 1945, it was

Voted, That the determination of the Certified Public Accountancy Committee on Grievances in the matter of the application for the revocation of the certified public accountant certificate heretofore granted to Erwin H. Lyons, New York, be accepted and sustained; that, in compliance with the recommendation of said committee, certificate No. 9633, issued under date of May 15, 1942, to said Erwin H. Lyons, permitting him to practice as a certified public accountant in the State of New York, and his registration or registrations as a certified public accountant, wherever they may appear, be suspended for a period of one year from the date of service of the order effecting such suspension; and that the Commissioner of Education be empowered and directed to execute, for and on behalf of the Board of Regents, all orders necessary to accept the determination of said Committee on Grievances and to carry out the terms of this vote.

Adopted June 27, 1958

Upon the report of the Regents Committee on Discipline, made in accordance with the provisions of chapter 514 of the Laws of 1945, it was

Voted, That the findings of the Certified Public Accountancy Committee on Grievances in the matter of the application for the revocation of the certified public accountant certificate heretofore granted to Meyer Kiel, New York. be accepted and sustained; but that the recommendation of said Committee, that the certified public accountant certificate issued to said Meyer Kiel be suspended for a period of three years, be modified, and that certificate No. 3342, issued under date of February 11, 1931 to said Meyer Kiel, permitting him to practice as a certified public accountant in the State of New York, and his registration or registrations as a certified public accountant, wherever they may appear, be suspended for a period of two years from the date of service of the order effecting such suspensions; and that the Commissioner of Education be empowered and directed to execute, for and on behalf of the Board of Regents, all orders necessary to accept the determination of said Committee on Grievances, as herein modified, and to carry out the terms of this vote.

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, CPA

The Urgency of Continuing Education

The above caption is the front-cover title of the 1958 annual report of the American Institute of Certified Public Accountants. Its spotlight position is indicative of the importance attributed to this main theme of the annual report.

It has been apparent for a long time that the accounting graduate requires considerable practical training before he can truly comprehend his functions and realize his potentialities. Much time and thought have been given to this problem. Action has been taken by some firms, mostly large ones, to furnish their own staff training and continuing education courses. Also, many practicing CPAs realize the need for a brush-up or advanced course.

The Institute, recognizing that many practitioners, perhaps a majority, cannot themselves provide adequate courses for their small staffs, will undertake a program of continuing education that will be available to staff members and principals at convenient locations. Development and organizational work is underway and adequate funds have been budgeted to assure its sound implementation. Though the annual report discussion of the project indicates that individual practitioners and partners are to be included in the student body, it is not yet known whether there will be any specialized courses for these principals.

The success of the program, in the individual case, depends on whether accounting firms will function in such manner that what is preached in the classroom will be practiced on the job and in the office. Standards of performance will soon be forgotten if they are not utilized in daily practice. Consider the disillusionment of staff men who find out through such courses how inadequate are their firm's standards and policies. Employing accountants must be mindful of this responsibility when authorizing their staff to enroll for courses. On the other hand, it is hoped that the curriculum and the lecturers will not overlook the fact that a preponderance of the practitioners operate on a small scale, that they are confronted constantly by economic considerations, and that write-up services

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are a major factor in many small-client practices.

Keeping Track of Minor Time Expenditures

Practitioners who recognize that considerable time is expended in the service of their clients through the medium of telephone calls, letters, and minor matters of a review or staff discussion nature, are concerned about the annual aggregate of such time. In some instances, the total time adds up to a number of days each year and would have a significant effect on the client profitability. Applied to all of a practitioner's clientele, the aggregate can be substantial and have a material billing value.

Recording the minor time expenditures could be an onerous and expensive job unless a speedy, easy mechanism is used. The form here reproduced requires merely the recording of a stroke for each letter, phone call or other controlled operation. Each stroke might represent ten minutes; thus an extended phone call would merit two or three strokes. The form is kept in a spot on the desk where it is reached and used conveniently.

COMMUNICATION AND SUNDRY TIME RECORD

PARTNER________________ WEEK ENDING__________

CLIENT	MON.	TUES.	WED.	THURS.	FRI.	SAT.	TOTAL	
							STROKES	HOURS

TOTALLED AND POSTED BY________________ DATE__________

Clients' names are typed in advance and a supply of such forms, covering only a few months needs, may be kept on hand. The total weekly time is posted to the individual client's time record. Matters involving more than

say, a half-hour's time, or requiring explanatory details, should not be recorded on this form.

Accountants' Sleep Habits—Efficiency Factors

Sleep is a builder of health and of a clear mind. It is a vital process, and an understanding of certain fundamentals of this still mysterious process can have a significant effect on one's well-being and efficiency.

The number of hours one sleeps is not as important as how well one sleeps. Out of eight hours of sleep, only the first two are usually of real benefit; the others are not nearly as important. That is why some people can do very well with only five or six hours of sleep. Late sleepers are actually wasting time and indulging a bad habit.

Fatigue is not necessarily the cause of sleep; witness the fact that lazy people usually sleep more than others, and that over-fatigue often causes sleeplessness. The two factors conducive to sleep are muscular relaxation and monotony. One can actually coax sleep by relaxing every muscle in the body. A cramped position retards relaxation and therefore prevents sound sleep.

A quiet room is best for sound sleep. However, one can be lulled to sleep by repetitive, monotonous noises, but sleep so obtained is not the most restful kind. Noise of even moderate levels, it should be understood, can be harmful, in varying degrees, whether one is awake or asleep.

Insomnia is considered by many scientists frequently only the result of a state of mind. Some insomnia sufferers, it is contended, really are seeking something to talk about, or endeavor to attract sympathy — whether they realize it or not. People who nap during the day usually need much less than average sleep at night. Thus, if one intends to stay out late of an evening, a nap during the day will generally be found helpful. Sufferers of insomnia may possibly obtain relief by just not talking about it. If not, they should consult a doctor or a psychiatrist.

Excitement is not conducive to sleep. Thus, late card playing or attention to exciting midnight radio or television programs, or the late reading of exciting novels, will usually discourage sleep. Worry and imagination can be the causes of sleeplessness. Therefore, accountants who work at home in the evening, or who bring home their mental problems for churning prior to going to bed, will find it difficult to fall asleep. They may eventually fall asleep in an unrelaxed state, and consequently not enjoy a truly sound, refreshing sleep.

Of considerable importance is the kind of bed one sleeps in. For the best results, the blankets should not be heavy and bear down on the sleeper. The mattress should be firm and not bumpy. The spring should not sag excessively nor side sway, and the underside of the bed should be protected against cold drafts.

Payroll Tax Notes

Conducted by Samuel S. Ress

New York State Unemployment Insurance Tax Rates for 1958

The unemployment insurance tax on 1958 taxable payrolls averaged 1.60 per cent for the 295,040 covered employers in New York State. For the 166,762 employers who qualified for experience rating this year, the average rate was 1.45 per cent. Some 86,000 new firms received 2.7 per cent tax rates, and some 42,000 employers with unsatisfactory "experience rating" were taxed at 2.8 per cent of their taxable payrolls. Such employers may be taxed at 3.0 per cent in 1959 and 3.2 per cent in 1960 if they continue their unsatisfactory "experience" by showing "negative account" balances in their individual employer accounts, or if they are delinquent in filing required contribution and employment information reports required by the Industrial Commissioner.

Individual employer rates ranged from a low of 0.6 per cent to a high of 2.8 per cent of taxable payroll. These rates included the 0.1 per cent subsidiary tax added to the computed experience rate of employers in 1958. No subsidiary tax will be assessed on taxable payrolls for 1959. However the 1959 experience rate maximum for qualified employers was raised to 2.9 per cent from the former 2.7 per cent provided before the 1958 unemployment insurance law amendments.

For the 95 firms with $10 million or more each in annual taxable payrolls, the average 1958 tax rate was 1.15 per cent. For 22,500 firms with less than $5,000 each in annual taxable payrolls, the average tax rate based on "experience rating" was 2.04 per cent.

Apparel and construction firms, as in past years, had the highest average tax rates in 1958, 2.38 per cent and 2.42 per cent, respectively. However, it is interesting to note that even in the apparel manufacturing and in the construction industry 30 per cent of the employers with 46 and 45 per cent of the taxable payrolls respectively, received reduced rates. It would appear that neither size of firm nor the industry in which the employer operates preclude reduced unemployment insurance tax rates if appropriate measures are taken by the firm to protect its unemployment insurance experience rate account. Firms with reduced rates generally install unemployment insurance

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rate control systems and procedures suitable for the particular employer. In this way, substantial tax savings may be effected.

The following table prepared from information furnished by the Division of Employment of the New York State Department of Labor may be used by accountants who wish to compare the tax rates assigned to their clients for the year 1958 with the averages for the industry division or group.

1958 AVERAGE TAX RATE TABLE BY DETAILED INDUSTRY CLASSIFICATION FOR NEW YORK STATE UNEMPLOYMENT INSURANCE

(Average rate per dollar of taxable payroll)

Industry Rank in Group	Division and Group Classification	Firms Qualified for Experience Rating	All Covered Firms
	ALL INDUSTRIES	1.45	1.60
	Manufacturing	1.49	1.69
1.	Petroleum refining and allied industries	.74	.76
2.	Tobacco manufacturers	1.10	1.18
3.	Printing, publishing and allied industries	1.12	1.15
4.	Chemicals and allied products	1.14	1.16
5.	Instruments and related products	1.21	1.24
6.	Food and kindred products	1.24	1.39
7.	Primary metal industries	1.29	1.31
8.	Paper and allied products	1.31	1.36
9.	Other manufacturing	1.35	1.53
10.	Stone, clay, and glass products	1.40	1.48
11.	Machinery (except electrical)	1.43	1.49
12.	Metals and machinery	1.50	1.57
13.	Fabricated metal products	1.55	1.63
14.	Ordnance and accessories	1.62	1.63
15.	Electrical machinery, equipment and supplies	1.65	1.75
16.	Furniture and fixtures	1.70	1.82
17.	Transportation equipment	1.75	1.85
18.	Rubber and misc. plastic products	1.75	1.89
19.	Lumber & wood products (except furniture and fixtures)	1.81	1.95
20.	Textile mill products	1.87	2.21
21.	Apparel	2.04	2.38
	Nonmanufacturing industries	1.42	1.53
1.	Electric, gas and sanitary services	.67	.68
2.	Pipeline transportation	.81	.81
3.	Communication	.82	.82
4.	Local railway and buslines	.95	.98
5.	Transportation and other public utilities	1.16	1.20
6.	Air transportation	1.26	1.27
7.	Mining	1.48	1.68
8.	Trucking and warehousing	1.49	1.57
9.	Transportation services	1.50	1.55
10.	Agriculture, forestry and fisheries	2.13	2.37
11.	Contract construction	2.26	2.42
	Wholesale and Retail Trade	1.41	1.49
	Wholesale trade	1.33	1.39
	Retail trade		
1.	General merchandise	1.23	1.25
2.	Food	1.31	1.38
3.	Automotive dealers and gasoline service stations	1.44	1.48
4.	Furniture, home furnishings and equipment	1.45	1.54
5.	Miscellaneous retail stores	1.51	1.58
6.	Building materials, hardware and farm equipment	1.52	1.60
7.	Apparel and accessories	1.58	1.73
8.	Eating and drinking places	1.66	1.83
	Finance, insurance and real estate	1.08	1.13
1.	Insurance Carriers	.79	.80
2.	Holding & investment companies	.88	1.01
3.	Banks	.93	.93
4.	Insurance agents & brokers	1.04	1.07
5.	Credit agencies other than banks	1.26	1.27
6.	Combination real estate, insurance, loans, etc.	1.42	1.47
7.	Security and commodity brokers	1.43	1.44
8.	Real estate	1.51	1.63
	Service Industry	1.55	1.66
	Miscellaneous services	1.47	1.50

Industry Rank in Group	Division and Group Classification	Firms Qualified for Experience Rating	All Covered Firms
	Professional and business services		
1.	Legal services	1.16	1.19
2.	Educational	1.53	1.69
3.	Miscellaneous business services	1.60	1.66
4.	Medical & health services	1.76	1.80

Self-Employment Tax Rates

The social security tax rates on self-employment income, inadvertently, were incorrectly reported by this Department in the October 1958 issue. The rates are as follows: 1959, 3¾%; 1960-1962, 4½%; 1963-1965, 5¼%.

New York State Tax Forum

(Continued from page 826)

ally short-lived corporation sell capital assets without being considered a collapsible corporation so long as certain of the stockholders are not dealers in such assets.

To be taxed as a business rather than a real estate corporation is not a matter of election. One or the other tax applies depending on the facts. Article 9 applies to a corporation when it is "*wholly* engaged in the purchase and sale of and holding title to, real estate for itself, or *wholly* engaged in the business of subleasing real property held under a leasehold for a term of *twenty years or more*, by the terms of which the taxes on the real property are paid by the lessee corporation as part of the consideration for the leasehold . . ." (Sec. 182; Emphasis added.)

The activities and investments of an Article 9 corporation are narrowly defined. While such a corporation may, without losing its classification, possess without limitation, bonds, notes or other obligations of a purchaser of its property which it acquired on the sale of its property to the purchaser and which are secured by such property, it may not, however, invest more than 10 per cent of its average gross assets in other types of bonds and securities or in stock. Such a corporation may manage its own property, but it may not manage property of others for a fee, nor may it act as a real estate broker. Ownership of personal property, except that which is incidental to its ownership of real property, is proscribed. Also, if a business corporation controls a real estate corporation or if the same interests control the stock of the business and the real estate corporation, Article 9 does not apply.

It is apparent that while it is not a matter of choice to be taxed under Article 9 or 9A, it may be feasible to do business in such a manner as to have Article 9 apply rather than 9A if this result is desired.

One point must be noted. The course of procedure discussed is practical only when a new corporation is being organized. If the corporation were already classified as coming under Article 9, change of classification would invoke the additional tax of 2 per cent and there would be no advantage to be gained.

Federal Income Taxation

Decisions and Rulings — Richard S. Helstein, CPA

Commentary — Committee on Federal Taxation
Chairman, Herbert M. Mandell, CPA

Decisions and Rulings

Election With Respect to Consolidated Returns

The Commissioner has ruled that the Technical Amendments Act of 1958 which became law on September 2, 1958 contains provisions which make substantially less advantageous to affiliated groups as a class the continued filing of consolidated returns. Thus, under the provisions of Regulations Section 1.1502-41(a)(2), a new election is authorized to file separate returns "for the first taxable year for which returns are due to be filed after the date of enactment of the Technical Amendments Act of 1958." (Rev. Rul. 58-471, IRB 1958-39.)

It is important to note that the election is not geared to the taxable year of the group but to the due date of the return. Thus, a group whose taxable year ended June 30, 1958, prior to the enactment date, has the right to make an election since its return is due September 15, 1958, i.e., after the enactment date. Note also that the "due date" of the return includes any extensions of time granted by the Commissioner.

The Use of Form 1040A in 1958

The Commissioner has announced that the card return Form 1040A for 1958 has been revised to cover employees with gross income up to $10,000 and with no more than $200 in dividends, interest or other income not subject to withholding, instead of $5,000 which was the previous limit. If a joint return is filed, the limitations apply to the combined income.

However, since Section 6014, IRC 1954, provides for the Commissioner to compute the tax only if the gross income is less than $5,000 and the other income $100 or less, the simplification does not extend to the computation of tax. Despite the use of Form 1040A, taxpayers with $5,000 or more gross income must compute their own tax.

Form 1040A may not be used by taxpayers who wish to claim a credit for head of household, surviving spouse, dividends received, retirement income or estimated tax payment. Nor may it be used by taxpayers who claim a sick pay exclusion or deductions for travel, transportation or outside salesmen expense which should be shown on line 6(a) of Form 1040. (IRS News Release No. 236, September 4, 1958.)

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"Substantially All of the Properties"

In a decision under Section 474, IRC 1939 (dealing with Korean War Excess Profits Taxes), the Tax Court made certain holdings which acquire significance because of the somewhat similar wording of Section 368, IRC 1954. Section 474, IRC 1939, provides for the use of a credit of transferor corporations by a purchasing corporation where the purchasing corporation has acquired "substantially all of the properties (other than cash)" of the predecessor corporation.

Section 368(a)(1)(C) defines a corporate reorganization as one in which a corporation acquires "substantially all of the properties of another corporation" in exchange for all or a part of its voting stock.

In this case, the taxpayer was denied the use of the credits of certain predecessor corporations because the court held it did not acquire "substantially all" of the properties of the predecessor corporations. Because the acquiring corporation did not have sufficient funds, it was necessary for it to lease certain assets from the predecessor corporation until it was in a position to purchase them. The Tax Court held that a "lease" was not an "acquisition." Further, it held that in considering whether a corporation acquired "substantially all" of the properties, the liabilities assumed could not be netted against the assets. For example, if the predecessor corporation had gross assets of $1,000,000 and liabilities of $900,000, the transfer of assets of $100,000 would not constitute "substantially all." (*Virginia Stevedoring Corp.* 30 TC No. 105.)

Effect of Certain Statutory Mergers

Where a new corporation was organized in a different state for valid business purpose to acquire the total businesses of a parent and two subsidiaries, and the reorganization was effected through a statutory merger in which the new corporation was the survivor, without any change in the assets, liabilities or stockholders, the transaction, which meets the provisions of Section 332 (relating to non-taxability upon complete liquidation of subsidiaries), could qualify as a reorganization under both Section 368(a)(1)(A) (dealing with statutory mergers) and Section 368(a)(1)(F) (covering mere change in place of organization).

Revenue Ruling 57-276 (1957-1, CB 126) had provided that where a reorganization falls within both such subsections of the Code, Section 368(a)(1)(F) shall apply since it was not the intent of Congress that the provisions of Section 381(b) be defeated merely because an identity reorganization qualifies under some other provision of Section 368(a)(1). (In that ruling it was held that an identity reorganization would not break up a consolidated group.)

Accordingly, in the instant situation, the reorganization falls within Section 368(a)(1)(F) and therefore the provisions of Section 381(b) apply. Thus, the surviving corporation must file a single return including the operations of the parent company prior to the merger and its own operations from the date of the reorganization to the end of the taxable year. Thus, for purposes of carry-overs, this constitutes a single taxable year. The subsidiaries, however, must file returns covering their operations for their taxable years which end on the effective date of the merger. (Rev. Rul. 58-422, IRB 1958-34, 14.) Furthermore, the acquiring corporation may not carry back a net operating loss arising in a taxable year ending after the date of the merger to any taxable years of the transferor corporations.

Commentary

"Automatic" Change of Accounting Period

The provisions of the 1958 tax law relating to "small business corporations" will cause a renewed interest in the possibility of changing accounting periods for those corporations eligible to make the election to tax income to the shareholders and not to the corporations. A change of accounting period might be desirable to advance the date at which the election could take effect. Suppose a corporation on a calendar year basis has eleven shareholders but otherwise would qualify as a "small business corporation." Assume further that in February of 1959 all of the shares of one stockholder are redeemed so that the corporation would then qualify. If it continued on the calendar year basis all of its 1959 income would be taxed to the corporation. If, however, it could change its accounting period to the year ending January 31, it could make the election effective February 1, 1959 rather than January 1, 1960. Other common situations in which a change of accounting period might be desirable could be cited as, for example, a change to place an electing corporation on a different taxable year from that of its stockholders.

It is natural that first thought should be given to the possibility of effecting a change of accounting periods under the "automatic" rules contained in Regulations Section 1.442-1(c). However, to come within these rules strict adherence to the conditions required is necessary and several questions might be raised, particularly with regard to the requirement that no previous change in accounting period may have beer made within the ten prior calendar years.

It seems clear that this rule does not act as an automatic bar to corporations which have been in existence for less than the ten-year period. Such corporations necessarily must have *adopted* an accounting period at the outset, but adoption is not a *change* of accounting period. Thus, a corporation which was formed only five years ago may nevertheless qualify if it has not changed its period in the interim and it meets the other conditions.

A more uncertain question arises where, within the stipulated period, the corporation has changed to a 52-53 week year. (Note that this change could have been made without permission.) Does such a prior change of period disqualify the corporation from the automatic change rules of Regulations Section 1.442-1(c)?

Informal discussion with Internal Revenue Service personnel has indicated that the Service has not yet ruled on the point and differences of opinion

exist within the Service. In view of this, a definite possibility exists that a taxpayer, having made such a change, might be disqualified from making an automatic change.

It is interesting to observe that if a taxpayer who makes an automatic change in accounting period is examined and as a result of the examination his income is changed so that he no longer qualifies for the automatic change, he will nevertheless be treated as if he made a timely request for permission to change. The application will then be considered on its merits. However, "subsequent adjustments" apparently would not affect qualification under "the no change in ten years" rule, and a subsequent holding that the taxpayer did not meet this condition would leave the taxpayer no protection.

Where these circumstances exist, it would probably be wise to submit a request for permission to change instead of relying on the automatic rules.

Basis of Stock in Real Estate Cooperatives

The specific terms of a lease between a tenant-stockholder of a cooperative corporation and the corporation can have extremely important tax consequences. Tenant-stockholders of real estate cooperatives pay in lieu of rent their respective shares of the operating expenses and carrying charges of the corporation. Ordinarily, the entire amount received by the corporation constitutes rental income. Under Section 216 the tenant-stockholder is given the right to deduct on his personal income tax return his proportionate share of real estate taxes and mortgage interest paid by the cooperative corporation. The balance of the monthly payments made by the tenant-stockholder is considered to be a personal expense which is not deductible by him unless he is using a portion of the apartment for business purposes.

Where, however, under specific terms of the lease a portion of the monthly payments to be made by the stockholder-tenant is stated to be attributable to the amortization of the corporation's mortgage indebtedness or any other capital expenditures, such portion does *not* constitute gross income to the corporation. Rather, such amounts have been held to be in the nature of voluntary assessments upon the stock and, as such, represent additional cost of such stock and a capital contribution to the corporation (IT 1469, I-2 CB 191; *874 Park Ave. Corp.*, 23 BTA 400).

Thus, for example, assume that a tenant-stockholder pays $200 monthly to the corporation as his share of the carrying charges. Under a specific provision of the proprietary lease, so much of the payments received from the tenants as may be devoted to the payment of the principal of the mortgage or any other capital expenditure should be credited on the lessor corporation's books to a "paid-in surplus" account. Assuming that one-quarter of the tenant-stockholder's monthly payment was attributable to mortgage amortization or other capital expenditure, $50 each month should be credited to the "paid-in surplus" account on the corporation's books and the stockholder should be so advised. The stockholder's basis of his stock in the cooperative corporation would be increased by the amount of all such additions to "paid-in surplus."

The tax consequences flowing from this treatment of a portion of the monthly charges paid by the tenant-stockholder as "paid-in surplus" rather than income, are of benefit to both the corporation and the shareholder. The exclusion from the corporation's gross income of these amounts will normally

mean that deductions allowable for normal operating expenses including depreciation will exceed gross income so that there will be no resultant federal income tax liability to the corporation. On the other hand, the tenant-stockholder's basis of his stock will be increased by his proportionate share of payments for mortgage amortization and capital expenditures.

It must be emphasized, however, that in order to obtain this favorable tax treatment it is essential that the proprietary lease between the cooperative corporation and the tenant-stockholder be carefully drawn and specifically provide that a portion of the monthly payments be attributable to amortization of the corporation's mortgage indebtedness or to any other capital expenditures.

Section 337 and the Bad Debt Reserve

Section 337 provides, in general, that following the adoption of a plan of liquidation, gain or loss will not be recognized on the sale or exchange of the corporation's assets if the corporation is in fact liquidated within a year. Where a corporation which is being liquidated under Section 337 has a reserve for bad debts which has been allowed as a deduction for tax purposes, the question arises as to whether this reserve can give rise to taxable income in the year of liquidation.

The Internal Revenue Service has taken the position in Rev. Rul. 57-482 (1957-2CB49) that upon disposition of the accounts receivable, the need for maintaining a reserve for bad debts has ceased. Consequently, the reserve should be included in taxable income in the final federal income tax return. The Service considered and rejected the view that the bad debt reserve is a valuation reserve which reduces the basis of the outstanding accounts receivable. Thus, the loss sustained on the *sale* of receivables at less than their face amount is not recognized under Section 337, but the restoration of the bad debt reserve to income is taxable since the reserve was not sold or exchanged and, consequently, does not come within the purview of Section 337.

Consider the results of this ruling in the cases of Corporations A and B, both of which are liquidating under Section 337 and both of which have receivables of $100,000. In the past, both A and B have used the reserve method for bad debts and have accumulated reserves of $10,000. A *sells* its receivables for $95,000 and sustains a loss of $5,000, which is non-deductible under the terms of Section 337. At the same time, A is required to restore the bad debt reserve to taxable income; net result—$10,000 of taxable income. B collects its own receivables, rather than selling them, and ultimately collects $95,000. The unused portion of the bad debt reserve ($5,000) is then required to be included in taxable income; net result—$5,000 of taxable income, instead of $10,000, as in the case of A, merely because B collected its own receivables rather than selling them.

It may be possible to avoid the undesirable result in the case of A by simply writing off the uncollectible accounts against the bad debt reserve prior to selling the receivables.

Handling of the Unwieldy Form 1120

Practitioners have complained frequently about the unwieldy three-page Form 1120, and suggestions have been made to the Internal Revenue Service for redesigning this form to eliminate the third page; however, it does not look as though a revision will be forthcoming.

One practitioner suggests the following as a simple solution to the problem.

He has been tearing off the third page (numbered as pages 5 and 6) of the Form and inserting it inside the remaining Form in the same manner as a supporting schedule or the separate Schedule D. In this way, the form is complete and becomes less difficult to handle and bind.

It should be noted that the instructions at the top of page 5 state that pages 5 and 6 need not be submitted if all the information required on these pages is submitted on separate supporting schedules attached to the return.

The Dealer Reserve Dilemma

Dealers in such items as automobiles who find, after examination of their returns by the Treasury Department, that they are no longer able to defer year-end balances in the dealer reserve accounts, are apt to feel that this action is arbitrary and illogical. To the CPA involved in such a case, there is a comparable source of discomfiture as he finds his arguments bluntly turned aside by the force of Rev. Rul. 57-2 (1957-1 CB 17) which states in part that such "amounts withheld by a bank or finance company . . . constitute income . . . at the time the amounts are recorded on the books of the bank or finance company as a liability to the dealer." Yet such amounts are not generally available to the dealer at the time they are credited to his account. The usual stipulation that the amount of the reserve has to equal a certain percentage of the total paper outstanding raises the barrier to availability. The fact that certain of the funds cannot be used by the dealer except under the terms of the agreement with the lending institution leads the accountant to question the accruability of such income. Code Section 446 gives the taxpayer the right to regularly use the accrual basis of accounting and the Commissioner the right to correct a taxpayer's income to "such method as . . . does clearly reflect income." Let's turn, however, to the *Spring City Foundry Co.* case (292 U.S. 182 (1933); Aff'g. CA, 67 F.(2d) 385) for a succinct definition of the term "accrual basis." The Court stated: "Keeping accounts . . . on the accrual basis . . ., imports that it is the *right* to receive . . . that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." With the use of this line of reasoning, the Tax Court and the Commissioner were reversed by U. S. Courts of Appeal for the Fourth, Fifth and Eighth Districts, and by U. S. District Courts in North Carolina and Texas.

The dealer taxpayer finds himself, therefore, in an inequitable situation. He is currently taxed upon income that is not currently available to him, yet he is aware that similar taxpayers in certain areas in this country are, by incurring court costs, being offered more favorable and reasonable tax treatment. Why should he go to the expense of trying to recover taxes that he will ultimately pay? What advice can the CPA give in these circumstances? Nothing but—pay the tax, file a timely claim for refund, and wait.

The dilemma is posed. It calls for either acquiescence by the Commissioner or a well reasoned decision by the Supreme Court.

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